# United States Court of Appeals for the Second Circuit



**APPENDIX** 

United States Court of Appeals for the Second Circuit

AHMET ERTEGUN AND IOANA ERTEGUN,
Petitioner-Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee,

GERALD WEXLER AND SHIRLEY WEXLER,
Petitioner-Appellant,

VS.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant,

NESUHI ERTEGUN AND BELKIS ERTEGUN,
Petitioner-Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

On Appeal from the United States Tax Court

JOINT APPENDIX ON APPEAL

PAUL, WEISS, RIFKIND, WHARTON & GARRISON Attorneys for Petitioners-Appellants 345 Park Avenue New York, New York 10022 212 (644-8000)

Alfred D. Youngwood George P. Felleman Mark M. Weinstein

Of Counsel





PAGINATION AS IN ORIGINAL COPY

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## UNITED STATES TAX COURT

3830-71

DOCKET NO.

AIRCON COMPOSINI	- 1 TO ANA PROPERTY	APPEARANCES FOR PETITI		t-i- (Paul
AHMET ERTEGUN	and IOANA ERTEGUN	Alfred D. Youngwood	ifkind. Wharton	nstein (Paul, n & Garrison).
121 East 81st	Street	345 Park Avenue, No	ew York, New Yo	ork 10022
New York, New	York10028 PETITIONER,			
	vs.			
COMMISSIONER OF	INTERNAL REVENUE, RESPONDENT.			
Date	Filings and Proceedi	ing	Action	Served
Month Day Year		···•		
June 8, 1971	PETITION FILED: FEE PAID	June 8, 1971		June 14, 197
June 8, 1971	RECUEST by Petr. for trial at Ne	ew York, N. Y. filed	June 14, 1971	June 14, 197
Aug. 5,7971	ANSTER filled by Resn			Aug. 6,1971
Aug. 10. 1973	NOTICE of Trial on Nov. 5, 1973	3 at New York, N.Y.		Aug. 10, 19
Nov. 1, 1973	MOTION by Petr. for continuance	from November 5, 1973		
	at New York, N.Y. trial session	on.	GRANTED Nov. 5, 1973	Nov. 19, 1973
Nov. 2, 1973	NOTICE of Hearing on petr. motic	on for continuance on		NOV 2 1973
	Nov. 5, 1973 at New York, New	York.		
Nov. 5, 1973	HEARING at New York, N.Y. before	Judge Raum		
	Cases CONTINUED GENERALLY			
	Petr Motion for Continuance G	RANTED		
Nov. 23, 1973	TRANSCRIPT of Nov. 5, 1973 rec'	d.		1
March 1, 1974	NOTICE of Trial on June 10, 19	74 at NY,NY.		March 1, 1974
June 13, 1974	TRIAL at New York, N.Y. before	Judge Quealy.		
	George Felleman (Allowed to a	ppear for Petr. (Not		9
	Admitted to practice)	•		
	Stipl. of Facts (with att. e	oths.) filed.		
	Joint motion to Consolidate	dkts 3830-71,3831-71,		· .
	3868-71 & 3908-71 for Trial.	Briefing & Opinion:		
	filed Granted & Served.			JUN 13 1974
	(continued t	o page 2)		May 1970

3830-71

AHMET ERTECHN	& IOANA ERTEGUN, ET AL	PETITIONER	PAGE 2
Date Month Day Year	Filings and Proceedings	Action	Served
Min. con't.	ORIGINAL BRIEFS DUE - Sept. 11, 1974		
	REPLY BRIEFS DUE - Oct. 11, 1974		
-	SURMITTED TO JUDGE QUEALY	i .	1
June 27, 1974	TRANSCRIPT of June 13, 1974 received.		
	BRIEF for Petr. filed.		SEP 1 2 1974
	BRIEF for Respondent filed.		SEP 1 2 1974
	REPLY BRIEF for Resp. filed.		OCT 15 1974
	REPLY BRIEF for Petr. filed.		OCT 1.5 1974
Feb. 13, 1975	MEMORANDIM FINDINGS OF FACT AND OPINION, Judge Quealy.  Decision will be entered under Rule 155.		EB 1 3 1975
V 21 107E			
May 21, 1975 May 23, 1975	DECISION ENTERED, Judge Quealy.		May 23, 1975
ray 23, 1775	APPELIATE PROCEEDINGS		
June 23, 1975	MOTION to fix amount of bond filed by Petrs.		June 25, 1975
June 24, 1975	ORDER fixing amount of bond at \$103,901.26, upon		
	motion by counsel for petrs.		June 25, 1975
June 30, 1975	ORDER AMENDING ORDER FIXING AMOUNT OF BOND due to		
	change in interest rate to 9 per centum beginning		
	July 1, 1975, fixing bond at \$109,125.91.		July 1, 1975
Aug. 15, 1975	BOND in the amount of \$109,125.91, with Midland		
	Insurance Company, as surety, approved and ordered		•
	filed.		1
Aug. 15, 1975	NOTICE OF APPEAL to U.S.C.A., 2nd Cir., filed by Petrs		Aug. 18, 197
Aug. 18, 1975	NOTICE of Filing with copy of notice of appeal sent to		
	Mr. Meade Whitaker, Chief Counsel.		Aug. 18, 197
Aug. 18, 1975	NOTICE, to parties, of assembling and date for trans-		
	mission of the record.	<u> </u>	Aug. 18, 197

### GENERAL DOCKET

3831-71 DOCKET NO. APPEARANCES FOR PETITIONER: Alfred D. Youngwood, Mark M. Weinstein (Paul, GERALD WEXLER and SHIRLEY WEXLER Weiss; Goldberg, Rifkind, Wharton & Garrison), 345 Park Avenue, New York, New York 10022 Gardiners Pay Estates Fast Marion, New York PETITIONER. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT. Date Filings and Proceedings Action Sem! Month Day Year June 14, 1971 PETITION FILED: FEE PAID June 8, 1971 June 8, 1971 GRANTED June 14, 1971 June 14, 1971 RECUEST by Petr. for trial at New York, N.Y. filed June 8, 1971 Aug. 6,1971 ANSTER filed by Resp Aug. 5,1971 Aug. 10, 1973 NOTICE of Trial on Nov. 5, 1973 at New York, N.Y. Aug. 10, 1973 MOTION by Petr. for continuance from November 5, 1973 Nov. 1, 1973 GRANTED Nov. 5, 1973 Nov. 19, 1973 at New York, N.Y. trial session. NOV 2 1973 NOTICE of Hearing on petr. motion for continuance on Nov. 2, 1973 Nov. 5, 1973 at New York, New York. HEARING at New York, N.Y. before Judeg Raum Nov. 5, 1973 Cases CONTINUED GENERALLY Petr Motion for Continuance -- GRANTED Nov. 23, 1973 TRANSCRIPT of Nov. 5, 1973 rec'd. March 1, 1974 NOTICE of Trial on June 10, 1974 at NY, NY. March 1, 1974 TRIAL at New York, N.Y. before Judge Quealy. June 13, 1974 George Felleman(Allowed to appear for Petr.(not admitted to practice) Stip. of Facts (with att. exhs.) filed - Joint motion to Consolidate dkts 3830-71,3831-71, 3868-71 & 3908-71 for Trial, Briefing & Opinion: JUN 13 1974 filed - Granted & Served.

(continued to page 2)

DOCKET NO. 3831-71

(Continuation)

AHMET ERTEGUN	& IOANA ERTEGUN, ET AL	PETITIONER	PAGE 2
Date Month Day Year	Filings and Proceedings	Action	Served
Min. Con't.	ORIGINAL BRIEFS DUE - Sept. 11, 1974		3
	REPLY BRIEFS DUE - Oct. 11, 1974		
• •	SURMITTED TO JUDGE QUEALY	-	
June 27, 1974	TRANSCRIPT of June 13, 1974 recevied.		1.
Sept. 11,197	4 BRIEF for Petr. filed		SEP 1 2 1974
Sept.11,1974	BRIEF for Resp. filed.		SEP 1 2 1974
Oct.11,1974	REPLY BRIEF for Resp. filed.		OCT 1 5 1974
ct. 11, 1974	REPLY BRIEF for Petr. filed.		DCT 15 1974
Feb. 13, 1975	MEMORANDUM FINDINGS OF FACT AND OPINION, Judge Quealy.		FER 1 3 1975
	Decision will be entered under Rule 155.		
May 21, 1975	ACREED COMPUTATION filed.		
May 23, 1975	DECISION ENTERED, Judge Quealy.		Kay 23, 1975
	APPELIATE PROCEEDINGS		
June 23, 1975	MOTION to fix amount of bond filed by Petrs.		June 25, 1975
June 24, 1975	ORDER fixing amount of bond at \$87,622.61, upon motion		
	by counsel for petrs.		June 25, 1975
June 30, 1975	ORDER AMENDING ORDER FIXING AMOUNT OF BOND due to		
	change in interest rate to 9 per centum beginning		
• :	July 1, 1975, fixing bond at \$92,028.52.		July 1, 1975
Aug. 15, 1975	BOND in the amount of \$92,028.52, with Midland		
	Insurance Company, as surety, approved and ordered		
	filed.		
Aug. 15, 1975	NOTICE OF APPEAL to U.S.C.A., 2nd Cir., filed by Petrs		Aug. 18, 197
Aug. 18, 1975	NOTICE of Filing with copy of notice of appeal sent to		Aug. 18, 197
	Mr. Meade Whitaker, Chief Counsel.		
Aug. 18, 1975	NOTICE, to parties, of assembling and date for trans-		Aug. 18, 197
·	missign of the record.		

## UNITED STATES TAX COURT GENERAL DOCKET

			DOCKET NO	3000 11
Nesuhi Ertegun	and Belkis Ertegun Weiss	APPEARANCES FOR PETITION Mark M. Weinstein and A Goldberg, Rifkind, Whan	ton & Garrison	gwood (Paul, n), 345 Park
Nesuhit 10	and Belkis Ertegin Weiss, Fifth Ave., New York, N.Y. Ave O Park Ave., New York, N.Y.	nue, New York, New York,	10022.	
	PETITIONER,	ADDRESS		
COMMISSIONER OF	VS. , INTERNAL REVENUE, RESPONDENT.			
Date ,	Filings and Proceed	ings	Action	Served
Month Day Year				
June 9, 1971	PETITION FILED: FEE PAID Jun	e 9, 1971	GRANTED:	June 16, 1971
hine 9, 1971	REQUEST by petr. for trial at Ne	w York, New York	June 16,1971	June 16, 1971
	ENTRY OF APPEARANCE by Alfred D.	Youngwood for petr.		June 18, 1971
June 17, 1971 June 17, 1971	DESIGNATION of counsel Youngwood	d to receive service.		June 18, 1971 Aug. 6, 1971
Aug. 5, 1971	ANSWER filed by Resp.	ř		
Aug. 10, 1973	NOTICE of Trial on Nov. 5, 1973	at New York, N.Y.		Aug. 10, 1973
Nov. 1, 1973	MOTION by Petr. for continuance	from November 5, 1973	GRANTED	
	New York, N.Y. trial session.		Nov. 5, 1973	Nov. 19, 1973
Nov. 2, 1973	NOTICE of Kaaring on Petr. motio	on for continuance on		NOV 2 1973
MOVE ET -ZIP	Nov. 5, 1973 at New York, New			
Nov. 5, 1973	HEARING at New York, N.Y. before			
	Cases CONTINUED GENERALLY			1
	Petr Motion for Continuance	GRANTED		
	3 TRANSCRIPT of Nov. 5, 1973 rec		4	March 1, 1974
	NOTICE of Trial on June 10, 19			
June 13, 197	I TRIAL at New York, N.Y. before	Judge Queary.		
	George Felleman (Allowed to	appear for Petr.) not		
	admitted to practice)	κ.		
	Stip. of Facts (with att.	xhs.) filed.		
	Joint motion to Consolidate	dkts 3830-71,3831-71,	-	1
	3868-71 & 3908-71 for Trial (Continued to page	, Briefing & Opinion:		Form No. 34 May 1970

AHMET ERTEGUN	& IOANA ERTEGUN, ET AL	PETITIONER	PAGE 2
Date Month Day Year	Filings and Proceedings	Action	Served
Min. cont.	filed - Granted & Served.		JUN 1 3 1974
2211	ORIGINAL BRIEFS DUE - Sept. 11, 1974		
	REPLY BRIEFS DUE - Oct. 11, 1974		
	SUBMITTED TO JUDGE QUEALY		1
une 27, 1974	TRANSCRIPT of June 13, 1974 received.		
	BRIEF for Petr. filed.		SEP 1 2 1974
	BRIET for Resp. filed.		SEP 1 2 1974
	REPLY BRIEF for Resp. filed.		OCT 1 5 1974
	REPLY BRIEF for Petr. filed.		DCT 1 5 1974
FEb. 13, 1975	Vice O ander American Audio O colu		FEB 13 1975
FED. 13, 1973	Decision will be entered under Rule 155.		
May 21, 1975	AGREED COMPUTATION filed,		
May 23, 1975	DECISION ENTERED, Judge Quealy.		May 23, 1975
	APPELLATE PROCEEDINGS		
June 23, 1975	MOTION to fix amount of bond filed by Petrs.		June 25, 1975
June 24, 1975		-	
	by counsel for petrs.		June 25, 1975
June 30, 1975	ORDER AMENDING ORDER FIXING AMOUNT OF BOND due to		
	change in interest rate to 9 per centum beginning		3
	July 1, 1975, fixing bond at \$61,294.18.		July 1, 1975
Aug. 15, 1975	BOND in the amount of \$61,294.18, with Midland		
	Insurance Company, as surety, approved and ordered		
	filed.		
Aug. 15, 1975	NOTICE OF APPEAL to US.C.A., 2nd Cir., filed by Petrs		Aug. 18, 1975
Aug. 18, 1975	·	•	Aug. 18, 197
	Mr. Meade Whitaker, Chief Counsel.	-	+
Aug. 18, 1975	NOTICE, to parties, of assembling and date for trans- mission of the record.		Aug. 18, 1975

### [Stipulation as Filed] STIPULATION OF FACTS

IT IS HEREBY STIPULATED AND AGREED by and between the petitioners and the respondent, by their respective counsel, that for the purposes of these cases, the facts herein stated shall be taken as true; provided, however, that the parties reserve any objection as to materiality or relevance, and that this stipulation shall be without prejudice to the right of either the petitioners or the respondent to introduce upon the trial of these cases any other and further evidence not at variance with the facts herein stated.

- 1. Petitioners Ahmet Ertegun and Ioana Ertegun are husband and wife whose legal residence at the time of filing their petition was 121 East 81st Street, New York, New York 10028. They timely filed their joint Federal income tax return (Form 1040) for the calendar year 1967 with the District Director of Internal Revenue, Manhattan District, New York, and paid the tax shown on such return Acopy of the to be due. The original return is attached as Exhibit A.
- 2. Petitioners Gerald Wexler and Shirley Wexler, during the periods herein relevant, were husband and wife whose legal residence at the time of filing their petition was Gardiners Bay Estates, East Marion, New York. They timely filed their joint Federal income tax return (Form 1040)

for the calendar year 1967 with the District Director of Internal Revenue, Brooklyn District, New York. The Acopy of the original return is attached as Exhibit B.

- 3. Petitioners Nesuhi Ertegun and Belkis Ertegun, during the periods herein relevant, were husband and wife whose legal residences at the time of filing their petition were 1010 Fifth Avenue, New York, New York and 960 Park Avenue, New York, New York. They timely filed their joint Federal income tax return (Form 1040) for the calendar year 1967 with the District Director of Internal Revenue, Manhattan District, New York. The original return is attached as Exhibit C.
  - 4. Petitioner, Atlantic Record Sales Co., Inc. (here-inafter referred to as "Atlantic"), was a corporation organized under the laws of the State of New York, which was dissolved on December 1, 1967. Its last principal office was at 1841 Broadway, New York, New York. Atlantic timely filed its Federal U.S. small business corporation income tax return (Form 1120-S) for the taxable year ended May 31, 1967, and its Federal corporation income tax return (Form 1120) for the taxable period ended November 30, 1967, with the District Director, Mannattan District, New York, and paid the tax shown on its Federal corporation income tax return to be due. The original returns are attached hereto as Exhibits

D and E, respectively. Atlantic employed the accrual method of accounting for Federal income tax purposes.

- 5. Petitioners Ioana Ertegun, Shirley Wexler and
  Belkis Ertegun are petitioners in their respective cases
  solely by reason of their filing joint Federal income tax
  returns for calendar year 1967 with their respective husbands.
  Accordingly, hereinafter all collective references to the
  "individual petitioners" shall mean Ahmet Ertegun, Gerald
  Wexler and Nesuhi Ertegun, and references to "petitioner
  Wexler" shall mean Gerald Wexler.
- within the meaning of section 1371 of the Internal Revenue Code of 1954 (the "Code") and had a valid election in effect under section 1372 of the Code for its taxable year ended May 31, 1967. The individual petitioners were, during the period which commenced June 1, 1966, and ended in the latter part of November 1967, the owners of 8872 shares of common stock of Atlantic (hereafter the "Atlantic Common Stock"), which constituted all of its then issued and outstanding capital stock. Petitioner Ahmet Ertegun owned 3741 shares of Atlantic Common Stock, or approximately 42.17% of the shares outstanding, petitioner Wexler owned 2957 shares of Atlantic Common Stock, or approximately 33.33% of the shares outstanding; and petitioner Nesuhi Ertegun owned 2174 shares

of Atlantic Common Stock, or approximately 24.50% of the shares outstanding.

- 7. At the end of November 1967, the individual petitioners sold all of their Atlantic Common Stock to Atlantic Recording Corporation, a corporation organized under the laws of the State of Delaware, and a member of the "affiliated group" of corporations of which Warner Bros.-Seven Arts, Inc. was the "common parent" (as defined in section 1504 of the Code). Accordingly, Atlantic became a member of such affiliated group, and, pursuant to section 1372(e)(3) of the Code, its election as a small business corporation terminated with respect to its taxable period ended November 30, 1967.
- 8. Atlantic was engaged in the business of selling, at wholesale, phonograph records. During the periods here relevant, Atlantic sold phonograph records which were 45 rpm singles (hereinafter referred to as "singles") and 33 rpm albums (hereinafter referred to as "albums").
  - 9. During the periods here relevant, Atlantic sold regularly to 58 customers. Forty-one of such customers were distributors of phonograph records located throughout the United States (hereinafter referred to as the "customer-distributors"). The 17 remaining regular customers were mail-order houses, military post exchanges and exporters.

- , 10. During Atlantic's taxable periods ended May 31, 1967, and November 30, 1967, Atlantic granted to certain customers a 3% reduction of gross sales price of albums. Customers who were in the categories of mail-order houses, military post exchanges or exporters did not receive the reduction.
- 11. Atlantic maintained on its books two accounts, one of which is denominated the 3% Account and the other of which is denominated the 10% Account. The following amounts were included in the 10% Account:

		Opening Balance June 1, 1966 \$166,582.00
		Net addition for year ended May 31, 1967
2		Balance as of May 31, 1967
		Net decrease for period ended November 30, 1967 (\$ 58,971.30)
		Balance as of November 30, 1967
The	following	amounts were included in the 3% Account:
		Opening Balance Jume 1, 1966 \$ 45,944.00
		Net addition for the taxable year ended May 31, 1967
		Balance as of May 31, 1967

- the calendar year 1967, the individual petitioners, pursuant to section 1373 of the Code, included in their gross income their respective shares, under section 1373(b) of the Code, of the "undistributed taxable income" of Atlantic for the period ended May 31, 1967, which reflected the deduction from Atlantic's sales income of amounts added to the 3% Account and the 10% Account with respect to such year.
- Notices of Deficiency to each of the individual petitioners to increase the taxable income of Atlantic (and thereby to ratably increase each of the individual petitioners share of Atlantic's undistributed taxable income) by the balance in the 3% Account and the 10% Account as of the end of Atlantic's taxable year ended May 31, 1967. The parties agree and stipulate that if the Court determines that either such adjustment is correct, that an appropriate adjustment shall be made under Rule 155 to petitioner Atlantic's taxable income for the taxable period ended November 30, 1967, reflecting the adjustment to Atlantic's income for the taxable year ended May 31, 1967.

- 14. The parties agree and stipulate that the adjustment referred to in paragraph 13 above to petitioner Atlantic's income for the taxable period ended November 30, 1967, shall be computed under the following principles:
- (a) If the respondent's proposed adjustments with respect to the 3% Account and 10% account are incorrect, no adjustment shall be made to petitioner Atlantic's taxable income for the taxable period ended November 30, 1967;
- (b) If respondent's proposed adjustment with respect to the 3% Account is correct, and respondent's proposed adjustment with respect to the 10% Account is incorrect, an increase in the amount of \$43,000.21 shall be made to petitioner Atlantic's taxable income for the taxable period ended November 30, 196%;
- (c) If respondent's proposed adjustment with respect to the 10% Account is correct and respondent's proposed adjustment with respect to the 3% Account is incorrect, a reduction in the amount of \$58,971.30 shall be made to petitioner Atlantic's taxable income for the taxable period ended November 30, 1967; or
- (d) If respondent's proposed adjustments with respect to both the 3% Account and the 10% Account are correct, a reduction in the amount of \$15,971.09 shall be made to petitioner Atlantic's taxable income for the taxable period ended November 30, 1967.

agree and stipulate that the deduction for the addition to petitioner Atlantic's reserve for bad debts in the amount of \$24,000 is proper and that respondent's proposed disallowance of such deduction was incorrect.

/s/ Alfred D. Youngwood

Alfred D. Youngwood Counsel for Petitioners 345 Park Avenue New York, New York 10022

Meade Whitaker
Chief Counsel
Internal Revenue Service
(Sgd) THEODORE E. DAVIS - ENH

JUN 1 2 1974

By:

THEODORF E. DAVIS
Assistant Regional Counsel
26 Federal Plaza (12th Floor)
New York, New York 10007
Tel. No. 212-264-0270.

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DATE:

BEFORE:

APPEARANCES:

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UNITED STATES TAX COURT

AHMET ERTEGUN, et al

Petitioner

vs

COMMISSIONER OF INTERNAL REVENUE

Respondent

3830-71 3831-71 DOCKET NO. 3868-71 3907-71

3908-71

LOCATION OF HEARING: United States Tax Court

New York, New York

June 13, 1974

The Honorable William H. Quealy,

Judge

Alfred D. Youngwood, for the Petitioners

Mark M. Weinstein, for the Petitioners

E'. Noel Harwerth, for the Respondent

Stanley J. Goldberg, for the Respondent

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2		OPENING STATEMENTS		i	
3	Opening St	tatement on Behalf of the Petitioner	Page	4	
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5		EVIDENCE			
6		WITNESSES			
7	Petitione	r's			
8	WITNESS	DIRECT CROSS REDIRECT	RECROS	SS	
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14	6	promotional booklet, Atco, 10/66	17	19	
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16	* 8	credit memorandum, three percent dis-	20	2,2	
17		count, issued to Roberts Record Distributors, 7/67			
18	9	invoice to F&F Enterprizes, 5/67, for	31	34	
19		purchase of 650 singles			
20	Responden				
21	F	copy, sales returns and allowances account of Petitioner's records,	3	3	
22		modification of Paragraph 11 of stipulation			
00		efficient of Mr. Vogel 5/29/73	.37	38	

stipulation

G affidavit of Mr. Vogel, 5/29/73 37 38

H distributors computer print-out, 1967 57 59

as established

#### 17a

#### EXHIBITS

2 Joint

Number Description

1-A attachments to stipulation of facts - 3

through 5-E.

. 6

#### PROCEEDINGS

THE CLERK: Please be seated.

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3830-71 and 3831-71, 3868-71, 3907-71, 3908-71,

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Ahmet Ertegun and Ioana Ertegun, and related Petitioners.

5

MR. YOUNGWOOD: Alfred D. Youngwood, Mark M.

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Weinstein and George Fellowman for Petitioners. Your

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Honor, Mr. Fellowman is not admitted in this Court. He is

admitted to practice in New York State and in the local

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Federal courts, and I would like leave for him to assist

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and sit at the counsel table in this matter.

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THE COURT: Leave will be granted.

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MR. YOUNGWOOD: Thank you, Your Honor.

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MRS. HARWERTH: E. Noel Harwerth for Respondent.

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MR. GOLDBERG: Stanley J. Goldberg for the

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MRS. HARWERTH: Your Honor, at this time we have

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an original and four of a motion to consolidate, signed by

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both parties.

Respondent.

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THE COURT: The motion will be received and

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granted.

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MRS. HARWERTH: Also, Your Honor, at this time we would like to file a decision in the Atlantic Recording

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Corporation case.

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THE COURT: A decision?

MRS. HARWERTH: It has been settled, Your Honor.

THE COURT: Oh, I see. I see. The stipulation will be received, and a decision entered accordingly.

MRS. HARWERTH: All right, and Your Honor, we also would like to submit an original and one of the stipulation of facts with Exhibits 1-A through 5-E.

THE COURT: The stipulation will be received and made a part of the record.

Do you wish to give us that modification in the stipulation now?

MRS. HARWERTH: Your Honor, the stipulation is being submitted subject to modification of Paragraph 11. The modification appears in the sales returns of allowances account from Petitioner's books and records, which Respondent would like to submit as Respondent's Exhibit F.

THE COURT: All right. Respondent's Exhibit F purports to be a copy of that account, and it will be received as such, subject to the right of the Petitioner to check it in case it should prove otherwise, and it is the understanding of the Court that it is that account from which the figures appearing in Paragraph 11 were derived. The figures as they appear in Paragraph 11 do not appear in the same form in the account itself, but that these are the result of the figures that have been taken from that account.

MR. YOUNGWOOD: Your Honor, yes, those are --

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the figures in Paragraph 11 are included in that account.

THE COURT: All right. With that understanding, it will be received. And now you may make your opening statement, counsel.

OPENING STATEMENT ON BEHALF OF THE PETITIONER:

MR. YOUNGWOOD: Your Honor, despite the multiple captions on the pleadings in these cases, I can assure you that we are going to try what I think is a relatively simple case with a relatively simple issue. That issue involves the proper tax accounting for certain price discounts which were granted by Atlantic Record Sales Co., Inc., to its regular distributors in 1966 and 1967.

I don't believe there will be any significant dispute on the facts relating to these discounts. Before I describe any further the substantive issue, however, I would like to briefly tell you who the parties named in the captions are and describe to you the circumstances under which these cases arose.

For taxable year ended May 31, 1967, Atlantic

Record Sales Co., Inc., had a valid election in effect as
a Subchapter S corporation. That is why the individual

Petitioners, Ahmet Ertegun, Nesuhi Ertegun, and Gerald

Wexler, and their respective spouses, with whom they filed
joint returns, are parties to this proceeding. Messrs.

Ertegun, Ertegun and Wexler were the shareholders of

Atlantic at the time in question.

The only dispute with respect to the individual returns for the calendar year 1967 involves their respective shares of the undistributed taxable income of Atlantic for its taxable year ended May 31, 1967.

The issues with regard to the income of Atlantic relate only to the discounts I have previously referred to.

There are no other issues in dispute in the individual proceedings.

For Atlantic's subsequent taxable period, that is, June 1, sixty-seven through November 30, 1967, Atlantic's Subchapter S election was revoked and it filed a return as a regular corporation. The reason that this period is less than twelve months and that the Subchapter S election was revoked is that all of Atlantic's stock was sold to a corporate purchaser, and Atlantic became a member of the affiliated group of which the purchaser was a member, terminating Atlantic's taxable period on November 30, 1967.

It should be noted that one of the issues set out in the pleadings relating to Atlantic's taxable year ended on November 30, 1967, a bad debt question, has been settled, and this settlement is set forth in the stipulation. Thus the only reason that Atlantic itself remains in these proceedings is that depending upon the determination that is finally made by this Court with respect to

the undistributed taxable income of Atlantic for the May 31 year, the Subchapter S year, adjustments may have to be made to the taxable income of Atlantic for the November 30, 1967 year, the corporate -- the regular

Now, Your Honor, I just would like to return briefly to the issue which we are here to try today.

During the taxable periods in question, Atlantic bought from a related corporation long playing phonograph albums and singles which that corporation in effect manufactured Atlantic then regularly resold the albums and the singles to a network of unrelated distributors located throughout the United States. Atlantic also made a relatively small quantity of sales on a regular basis to mail order houses, exporters and military post exchanges. The vast bulk of its sales, however, were to its regular domestic distributors, which numbered forty-one in 1966 and 1967.

The issues before the Court relate only to the price discounts which were uniformly granted to these forty-one regular domestic distributors.

In 1966 and 1967, Atlantic granted these distributors a three-percent discount on purchases of albums, of thirty-three's, and a ten-percent discount on the purchase of singles, or forty-five's. Although these discounts were fixed at the time of each sale, the formal

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corporate year.

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paperwork with respect to the discounts was done on a quarterly basis after the close of each calendar quarter.

It is the Petitioner's position that under
Atlantic's accrual method of accounting, for Federal
income tax purposes, the amount of the price discounts,
both the three-percent and the ten-percent, properly
reduced the sales price of the albums and the singles
respectively at the time of sale, and accordingly properly
reduced Atlantic's sales income at such time. Petitioners
computed their Federal income tax liability on this basis,
and such computations, we submit, are correct.

The Internal Revenue Service disagrees, and that is why we are here today. Your Honor, we plan to call two witnesses to describe the relevant facts. Our principal witness is one of the senior executives of Atlantic, who has worked for the company and the successor company since 1962, and who is intimately acquainted with the facts and circumstances surrounding these discounts. The second witness is a representative of one of Atlantic's regular distributors for many years, including 1966 and 1967, who is familiar with the discounts at issue. Thank you.

THE COURT: Do the invoices set forth those discounts, or do you have distributor agreements, or was that just understood in the trade?

MR. YOUNGWOOD: Well, it was a little bit of

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both, Your Honor. We will introduce into evidence an invoice which does set forth in effect the ten-percent discount. We will introduce into evidence promotional material which sets forth the three-percent discount.

THE COURT: But in this area, you didn't have distributor agreements like you would have in other --

MR. YOUNGWOOD: My understanding is that there were no written distributor agreements.

THE COURT: All right. Thank you. Mrs. Harwerth?

OPENING STATEMENT ON BEHALF OF THE RESPONDENT:

MRS. HARWERTH: Yes, Year Honor. The issue before the Court this morning is whether Petitioner is entitled to deduct amounts attributable to reserves for sales returns and sales discounts for the taxable periods in question. As you know, Petitioner is an accrual basis taxpayer. Respondent contends that under the accrual method of accounting an expense is deductible in the taxable year in which all events have occurred which determine the fact of the liability and the amount of the liability, with reasonable accuracy, I might add.

Petitioner contends that certain customers were allowed a three-percent discount on all long playing albums purchased. Petitioner also contends that distributors were entitled to return ten percent of all single records they purchased from Petitioner. Petitioner had no

written contracts with its distributors regarding the three-percent sales discount or the ten percent return privilege. Only one class of distributor was entitled to the discount, the three-percent discount. Military post exchanges, mail order houses and exporters did not receive the three-percent discount.

Petitioner contends that the three percent was computed quarterly and credited to the selected distributors' accounts automatically. However, since Petitioner billed its customers in some instances on a thirty-sixty-ninety-day basis, the distributors would receive credit on amounts they had not yet paid.

Respondent contends that all events could not possibly have occurred to fix liability under the all events test until the bills were paid by the distributors. The ten-percent reserve for anticipated record returns was based on the total sales of single records. Petitioner did not sell the records to distributors on a consignment basis. Petitioner did not require the distributors to return current records. In fact, any single record could be returned to Petitioner for purposes of this credit, regardless of the age of the record. The distributors could take advantage of the ten-percent return at any time, or presumably, if they sold all the albums -- or, pardon me, the singles they had received from Atlantic,

they would never have to take advantage of the tenpercent return.

Distributors were not given the ten-percent credit until the records were actually received by Petitioner at one of its factories. The opening journal entry for sales returns and allowances is a credit from the prior year's additional debit. The prior year's final charge represents the estimated amount for sales returns and allowances. The final charge to the account is an estimate of anticipated credit to be given to customers.

Petitioner's profit figure was reduced by the anticipated amount for returns of sales and allowances in that year. Petitioner did not know at the end of the taxable year what amount of records would actually be returned. The reserve for future or contingent liabilities is not deductible; therefore, a distortion of income has occurred in the taxable years in question.

Thank you, Your Honor.

THE COURT: Thank you.

MR. YOUNGWOOD: Your Honor, I would like to call as my first witness Sheldon Vogel. Mr. Vogel? Would you step up? Thank you.

THE CLERK: You do solemnly swear the testimony you are about to give to the Court in this case shall be the truth, the whole truth, and nothing but the truth,

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THE WITNESS: I do.

THE CLERK: Please be seated. Would you state your name and address for the record, please, sir?

THE WITNESS: Sheldon Vogel. My address is Muhlenbrink Road, Colt's Neck, New Jersey.

SHELDON VOGEL, called as a witness, having been duly sworn, took the stand, was examined, and testified as follows:

#### DIRECT EXAMINATION

#### BY MR. YOUNGWOOD:

Neck is two words.

Q Could you spell that for the Court, Mr. Vogel?

A Yes. M-u-h-l-e-n-b-r-i-n-k, one word. Colt's

Q. For the record, Vogel is V-o-g-e-1.

Mr. Vogel, by whom are you employed, and what is your position?

A I am employed by Atlantic Recording Corporation.

I am senior vice president of finance.

Q Since when have you been employed by Atlantic?

A I have been employed by the present Atlantic since December of 1967, and since 1962 by the predecessor corporations.

. Q When you say the predecessor corporations, what do you mean by that?

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1	. A That's the Atlantic Record Sales Company and
2	Atlantic Recording Corporation, that were dissolved when
3	the merger took place with the purchaser.
4	Q What was your original position at Atlantic?
5	A I was comptroller and chief financial officer.
6	Q How long did you remain comptroller?
7	A For about three or four years, at which time I
8	became a vice president.
9	Q And when did you become a senior vice president?
10	A In 1971.
11.	Q If we focus our attention on the period prior
12	to December of 1967, what were your duties and responsi-
13	bilities as comptroller of Atlantic Recording Corp. and
14	Atlantic Record Sales?
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16	officer, I would be responsible for all financial arrange-
17	ments, accounting arrangements, credit controls with
18	distributors, loans, general accounting procedures, taxes,
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20	Q Did you During that period, did you deal
21	directly with customers?
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2	Q Were these dealings part of your responsibilities
2	during 1966 and sixty-seven?

Yes, they were.

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Q Mr. Vogel, would you briefly tell the Court your background prior to coming to Atlantic in 1962?

A Well, I graduated from the Wharton School of
Finance of the University of Pennsylvania in 1953. I was
in the Army for two years. From fifty-five to fifty-nine,
I was comptroller of a family business. From 1959 to 1962,
I was comptroller and chief financial officer of Barney's
Clothes here in New York, and since 1962 I've been with
Atlantic.

Q Would you briefly describe to us the principal business of the Atlantic companies?

A The principal business is the recording of music and the arranging for the production of that music, and at the same time selling to distributors.

Q How many customers did Atlantic Record Sales have on a regular basis during the June 1, sixty-six period through the end of 1967?

A In the area of sixty.

Q Were there separate classes of customers within this group?

A Yes, there were our regular distributors, which

-- there were forty-one at the time, and we had the post

exchanges, mail order houses, exporters, for the difference.

Q I understand that Atlantic Record Sales had two labels, the Atlantic Record label and the Atco label. What

practical purposes a ten-percent discount that we gave

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was the difference between those labels, and was there any difference in the way things were accounted for with respect to them?

A Actually, they were identical with regard to all procedures. It was simply a matter of different artists would be assigned to different labels, but with that one exception, everything was handled in the same manner.

Q Thus, I am going to ask you, as we go on, a number of questions, and I am not going to distinguish as to whether I am talking about something having to do with Atco or Atlantic. Would it be fair to say that whatever you might be saying about one label you would equally say about the other?

A Yes, that would always be true.

Q Are you familiar, Mr. Vogel, with the term, a three-percent functional discount?

A Yes, I am.

Q Would you describe to the Court what it was?

A A three-percent functional discount was a discount that we allowed to our regular distributors based on their album purchases. It was done on a quarterly basis, and this was -- we reimbursed the distributor for his functional discount with regard to the sales to subdistributors.

Q Could you tell us how the three-percent account

anticts and publishers, and it's for this reason that

was established?

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A Yes. When I came to Atlantic in 1962, the procedure at the time was that each of our regular distributors would submit on a quarterly basis copies of all of their invoices where they sold to these subdistributors. We would then compute and organize these papers, and based on that we issued a five percent functional discount to these distributors for that service. Within a year or two, I realized that this was a lot of additional work for the distributor as well as for us, and required a lot of time, and also caused delays in computing the discount. We computed over a several-year period what an average was, and we came to the conclusion that a three-percent overall uniform discount to all distributors would pretty much be in line with past experience, so at that time I obtained the approval of management to make that change.

Q And would you remember about when that took place?

A Between 1964 and 1965.

Q So that in 1966 and 1967, was the previous practice in effect, or was it a flat three percent for everybody?

A It was a flat uniform three percent discount at that time.

Q When Atlantic instituted its flat three-percent

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discount in sixty-four or sixty-five, did it advise its

distributors -- I should say, when I talk about distributors

I would like to confine it, and it really will be confined

with the rest of my discussion with you to the forty-one

regular domestic distributors that you mentioned before.

So that if I can go back, when you instituted the three
percent functional discount, did you advise the distributors

of the change in practice?

A Yes, we did. We sent each of our regular distributors a letter at that time explaining the difference and the change.

Q Do you have a copy of that letter?

A No, we do not. I had my bookkeeper search the files, but this was ten years ago, and we can't seem to find one.

Q Do you recall at all what it said, in general?

A Basically, it was just a description of the change. It was a description of the fact that the five percent had averaged out to three percent on overall album purchases, and that we would make the credit automatic in the future, and there would be no further need for them to submit duplicate invoices to us.

Q Was the three-percent discount reflected in any other writings that were sent to distributors?

A Well, throughout the years, every time we had a

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special convention or special promotion, in indicating to the distributors what their base price was, and at that time there usually was an additional benefit or discount for the special promotion, we always indicated the usual three-percent discount as a reduction of their base price. MR. YOUNGWOOD: I would like to have something marked for identification. THE CLERK: Petitioner's Exhibits 6 and 7 are marked for identification. MR. YOUNGWOOD: I am giving to counsel for the Respondent copies, and if I might, a copy to the Court. Your Honor. THE COURT: Thank you. BY MR. YOUNGWOOD: (Resuming)

Q Mr. Vogel, I am handing you Petitioner's

Exhibits 6 and 7 which have been marked for identification,

and I am asking you if you would please identify them.

A Yes, this is one of our routine promotional booklets that we gave out during our various conventions. This one is dated October, 1966. There are two of them simply because one is for the Atlantic distributors and one is for the Atco distributors.

Q To whom were the materials given, did you say?

A These were given to all of our regular

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distributors, which would be all forty-one at the convention

Q Were similar materials prepared at other times?

A' Yes. These things took place normally about twice a year, and at every one of these conventions, or during these programs, materials similar to this would be given out to all of our distributors.

Q Mr. Vogel, were Exhibits 6 and 7 which have been marked for identification prepared in the ordinary course of Atlantic's business?

A Yes, they were.

Q Was it the regular course of Atlantic's business to prepare such papers and documents?

A Yes, it was.

Q Mr. Vogel, would you read the sentence at the top of Page 2 of the Atlantic materials?

A "Your usual three-percent discount on all net LP purchases will be given quarterly."

Q Mr. Vogel, would you look at the second page of the Atco materials? Is the same statement there?

A Yes, it is.

Q Do these references to your usual three-percent discount, et cetera, refer to the three percent functional discount you just testified about?

A Yes, they do.

MR. YOUNGWOOD: Your Honor, I would like to

offer into evidence Petitioner's Exhibits 6 and 7 which have been marked for identification.

THE COURT: Any objection?

MRS. HARWERTH: No, Your Honor.

THE COURT: They will be received.

MRS. HARWERTH: Your Honor --

THE COURT: Yes?

MRS. HARWERTH: Can I interject something a moment? Respondent served a subpoena on Petitioner with regard to exactly this material last Friday. We didn't see it until now. Although I think that we can probably handle it, I wanted to note that on the record, that this material was subpoenaed, specifically.

MR. YOUNGWOOD: Your Honor, I would like to hand up to the Court a copy of the subpoena. I would have been happy to supply to the Respondent had it been requested, but I don't believe it was. I do not believe, Your Honor, that these are books of account, credit memoranda, or invoices, or are lists prepared by distributors which were sent to Atlantic.

THE COURT: Well, we have them anyway now, so -- BY MR. YOUNGWOOD: (Resuming)

Q I am sorry if the Respondent thinks it was misled, but I did not read the subpoena as covering these documents.

Mr. Vogel, would you describe the billing

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procedures which were followed with respect to your dealing with the distributors with respect to this three percent functional discount?

A Well, when the distributor made purchases of the albums, they would be billed at the regular full wholesale price. At the end of the calendar quarter, we would obtain our data processing reports for each quarter which would break down the sales by distributor for albums and for singles, and based on that report, we would compute the three percent discount that the distributor would be entitled t. This would normally be two to three weeks after the calendar quarter was over, and these credits were then issued for the discount uniformly to all the distributors at that time.

MR. YOUNGWOOD: Might I have this marked for identification?

THE CLERK: Petitioner's Exhibit 8 is marked for identification.

BY MR. YOUNGWOOD: (Resuming)

Q Let the record show I am giving a copy of
Petitioner's Exhibit 8 which has been marked for identification to Respondent, and Your Honor, a copy to the Court.

Mr. Vogel, I am putting in front of you Petitioner's Exhibit 8 which has been marked for identification, and I ask you if you can identify that document.

A Yes. I can. This is the credit that was issued to our regular St. Louis distributor, Roberts Record. Distributors, in July of 1967, and it reads, for the three-percent functional discount, in the amount of \$2,188, approximately, for the June quarter of 1967.

Q Was this the standard form of credit memorandum issued in 1960 and sixty-seven?

A Yes, we had only one form, other than the two names, one for Atlantic, one for Atco, so this would be the standard form used.

Q Can you tell us -- I think you have in some ways already, but will you -- precisely what this credit memorandum relates to?

A It relates to the three percent discount that was earned by this distributor for the June, 1967 quarter, and is similar to those issued to all of our other distributors.

Q So this credit memorandum is an exmaple of similar credit memoranda which were in use during that period?

A Yes, it is.

THE COURT: When you say earned, what do you mean by the term, earned?

THE WITNESS: Earned meaning that they had the sales during that quarter. In other words, they earned

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three percent of whatever their net sales were for that period in albums. BY MR. YOUNGWOOD: (Resuming) Q Was this credit memorandum, Petitioner's Exhibit 8 which has been marked for identification, prepared in the 5 ordinary course of Atlantic's business? 6 Yes, it was. Was it the regular course of Atlantic's business 8 to prepare such documents? . 9. Yes, it was. 10 MR. YOUNGWOOD: I would like to offer -- What has 11 been marked for identification as Petitioner's Exhibit 8, 12 I would like to offer into evidence. 13 THE COURT: Any objection, counsel? 14 MRS. HARWERTH: No, Your Honor. 15 THE COURT: It will be received. 16 BY MR. YOUNGWOOD: (Resuming) 17 Mr. Vogel, is there any reason why the three 18 19 sales invoices which were sent to customers? 20 21 23

percent functional discount wasn't reflected on the original No particular reason. It was just convenient to do it on a quarterly basis, and probably it was based on the original concept where we had to wait for the duplicate invoices to be submitted to us by the distributors under the original plan, and at that time it was done

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quarterly, and when we made the conversion we kept it on the quarterly basis, but did it automatically rather than waiting for the invoices to come in.

Q In your experience, was there ever any question about regular distributors being entitled to the three percent functional discount on every purchase of Lp's during the 1966-167 period?

A No, there was never any question about it, and the distributors expected it, and as a matter of fact, it was given in all cases.

Q Was it in any way -- Was this functional discount dependent in any way on future purchases by a distributor?

A Absolutely not. It was based entirely on the purchases that they made during the prior quarter.

Q Do you know how customers would utilize the credit which was reflected in this memo?

A They would simply deduct it from their next remittance. Once the credit was issued, we would credit their account, and they would obviously debit our account and would deduct it the next time a remittance was due.

Q During 1966 and 1967, did all of your forty-one regular distributors receive this?

A Yes, they did.

THE COURT: May I interrupt you a minute, Mr. Youngwood? I want to clear something. This invoice is

dated, or this credit memorandum, July 19th. Now, did your billings have the normal cash discount for payment ten prox?

THE WITNESS: Well, or --

THE COURT: In addition. I mean, did they?

In other words?

THE WITNESS: Yes, they did.

THE COURT: So that actually, then, this would be issued normally after the records had in fact been paid for to which this applied, right?

THE WITNESS: No, not necessarily.

THE COURT: Well, assuming that your customers took advantage of the cash discount, it would be issued after that date, right?

THE WITNESS: Well, maybe I partially misled you.

We had a more complicated payment plan. The terms of our

album sales were as follows: It was one-third due

210 EOM, one-third due 2,10 EOM plus thirty, one-third

due 210 EOM plus sixty. In other words, an item bought

in April, for example, would be due one-third May 10th,

one-third June 10th, and one-third July 10th, subject to

the ten percent discount at those times, so that in this

case, many of those albums would not have been paid for.

THE COURT: In other words, this would be actually an adjustment on the amount that was owed for the

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purchases up to the date of the discount.

THE WITNESS: That's correct.

BY MR. YOUNGWOOD: (Resuming)

Q Mr. Vogel, just to follow that up a little bit, do you recall any instance in which any significant distributor was ever in a position during this period of time in which Atlantic owed it money as opposed to it owing Atlantic money?

A I don't recall any such time, no.

Q The Court mentioned something to you about the cash discounts, and I was going to ask you a little bit about that. Did you -- What was the policy with respect to the granting of cash discounts?

A Well, to repeat myself, the cash discount policy was a two percent cash discount on prompt payment of bills according to the terms. In the case of albums, as I said, it was what we call thirty-sixty-ninety, but actually due one-third the tenth of the following month and the second month and the third month, and if paid promptly at that time, the two-percent discount would then be earned.

Q And did you have a similar cash discount with respect to singles?

A Similar, except in the case of singles the entire invoice was due 210 EOM, so any singles, for

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example, bought in April, the entire invoice would be due May 10th, and if paid by May 10th it would earn a two-percent discount.

Q Could you explain to the Court, really as a technical matter, in terms of the --how you did the book-keeping, on the books of Atlantic Record Sales, how you accounted for this three-percent functional discount?

A Okay. Starting at the beginning, the initial sale would be made, of the gross amount, and of course at that time the accounts receivable for that customer would be charged and the sales account would be credited. At the time that the -- of the end of the calendar quarter or the fiscal year, as the case may be, we computed what the three-percent discount would amount to, and at that time we made an accrual, debiting or reducing the sales figure, increasing the returns and allowances, and decreasing the amount due from customers.

At the beginning of the following quarter or at the beginning of the next fiscal year, we would reverse that entry by increasing the amount due from the customers and decreasing the amount of the return. This would be a normal reversing entry. When the three-percent credit was then issued to the customer, again returns and allowances were increased and the amount due to the customer, or due from the customer, was decreased.

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Q Is this the same type of accounting policy you would -- in terms of setting up an accrual at the end of a quarter or the end of the fiscal year, that you followed, say, with respect to a telephone bill or a Conn Ed bill, or --

A Yes, this is -- this is the identical procedure for a payroll item or an unpaid telephone bill that would exist as of the end of the quarter or at the end of the fiscal year.

Q With respect to your tax returns, how did you reflect this three-percent functional discount?

A Well, the accrual that we made on our books as of the end of the fiscal year would be reflected in the tax return by an increase in the returns and allowances account.

Q All right. Mr. Vogel, I think at this point we will change our subject a little bit, and we have previously, as you know, been talking about LP's, thirty-three's, and now we will talk a little bit about what happened with singles, or forty-five's.

Mr. Vogel, do you recognize the term, tenpercent return privilege?

A Yes, I do.

Q Would you explain to the Court what that means?

Ten-percent return privilege was for all

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practical purposes a ten-percent discount that we gave
to our regular distributors based on the purchase of
singles. In effect, what we did was at the end of each
calendar quarter, we computed from our data processing
report the net singles purchases made by each of our
regular distributors, and we then issued a return authorization to each of our regular customers, to return ten
percent worth of their single purchases from that quarter,
based on our regular price of thirty-eight-and-a-half cents,
so that they could return them for full credit.

Q Why do you call it a discount?

A We gave it -- We called it a discount basically because the records that came back were absolutely worthless, and in fact, when they did come back we destroyed them. We either burned them or -- some dumped them down mine shafts, or plowed them under, or whatever. In effect, they had absolutely no value, and for that reason we considered it a discount.

Q If the singles were worthless, and as you say, you just destroyed them, why did you ask that they be returned?

A This was a function of our royalty policies.

Royalties are payable to artists on a retail list price of records sold net of returns. By taking back the returns, we in effect reduced our royalty liability to

our artists and publishers, and it's for this reason that we took the records back.

Q How did you know which ones were returned, which records were returned?

A When the distributor complied with the return authorization, he was requested to make out a detailed listing, record by record, of all the records that he was returning. When they went through our factories, they were counted, checked, and a receiving report was sent to us, again indicating the exact records that were returned.

THE COURT: Let me interrupt there if I may a second, counsel. Is it not true that on some purchases there might be no returns at all?

THE WITNESS: Well, the return privilege as we issued it, the discount as we issued it, was to return any single records ever purchased on any of our labels. It did not have to be the particular records that we sold that period, or didn't have to be in any particular breakdown.

THE COURT: And so that all distributors availed themselves of that privilege up to the maximum amount allowable?

THE WITNESS: Yes, they did. In fact, if a distributor didn't even have that number of singles in house, we have known cases where they have gone out and bought them from rack jobbers or customers at ten cents,

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even a nickel apiece, in order to fulfill their return authorization and obtain the full thirty-eight-and-a-half-cent credit for a record.

BY MR. YOUNGWOOD: (Resuming)

Q So have you told us that really the distributor himself didn't have to have bought that record from you? Somebody else may have bought it at any point in time?

A That's correct. There was never any attempt made to coordinate the records returned with the individuals' purchases.

Q Did Atlantic distributors fully utilize this ten-percent return discount during 1966 and 1967?

In fact, the distributors again expected it, and it was done on a routine quarterly basis, and in all cases that I can remember the returns were made properly and credit was issued.

I might add that there could be a dollar or two dollars' difference due to some bookkeeping problems, administrative problems, but surely well over ninety-nine percent really was taken due to the simple economics of the matter, that a worthless item was being returned for thirty-eight-and-a-half cents.

THE COURT: Do other people in the trade do this also or is this something that was peculiar to

Atlantic and Atco?

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THE WITNESS: No, it was not peculiar to Atlantic.

It was maybe not 100 percent uniform within the industry,

but certainly, I would say, the majority of record manu
facturers --

THE COURT: Say, RCA. Did they do this, too?

THE WITNESS: I do not know at that time what

their policy was. At this -- I would say the majority of
record companies at that time followed that practice.

MR. YOUNGWOOD: I would like to have this marked for identification.

THE CLERK: Petitioner's Exhibit 9 is marked for identification.

BY MR. YOUNGWOOD: (Resuming)

Q I am giving a copy of Petitioner's Exhibit 9 which has been marked for identification to counsel for Respondent, and a copy to the Court.

Mr. Vogel, I am putting in front of you Petitioner's Exhibit 9 which has been marked for identification, and I ask you if you can identify it, please.

A Yes. This is an invoice to one of our regular distributors, F&F Enterprizes, North Carolina. It is dated May, 1967, and it is an invoice for the purchase of 650 singles.

Q I notice -- You had indicated before that the

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price was thirty-eight-and-a-half cents. I look at 1 this invoice and there is nothing on it that indicates 2 thirty-eight-and-a-half cents. Would you explain that?

A Well, again, this is a function of our royalty policies, but if you will add up the total invoice of \$250.50 and divide it by the total units purchased of 650, it will come very close to thirty-eight-and-a-half cents. Our policy basically was, 1,000 purchased at full price of forty-five cents, and with that they receive 300 at seventeen cents, and of course this particular invoice is for exactly half of that quantity, and again the average price comes to thirty-eight-and-a-half.

Q Is this a typical invoice form which was used during 1966 and 1967 by Atlantic?

A Yes, this is the only form we used that year.

Are these invoice forms used for singles or for long playing?

Again, we only had one invoice form, and the same form would be used for both singles and albums.

Did this particular invoice relate to a shipment of singles?

Yes, it did.

How do you know that?

The record number, 2408X, the X suffix was our code for a single.

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Would you read to the Court the notation on the invoice at the top, which is under the space for the addressee?

It says, "Final sale, ro merchandise returnable without written authorization from this office. Ten-percent quarterly return privilege based on net paid sales of singles, forty-five rpm, two sides."

What is that net paid sales all about?

It was simply the net singles sales for the quarter. The word, paid, I see is in there, but it has absolutely no meaning, and it was never used, and basically it was simply the net singles sales for the quarter.

THE COURT: Before or after the cash discount? THE WITNESS: This would be the net sales before the cash discount.

BY MR. YOUNGWOOD: (Resuming)

If a distributor called up and basically said that I would like to return some additional singles, what would you do?

Well, we would have to make a decision. There was no requirement that we take back any returns other than, of course, this ten percent, but according to the value of the distributor to us, his promotional efforts on our behalf, we could very well authorize additional returns to be made by the distributor.

Did your distributors ever sell forty-five s

Q Mr. Vogel, was the exhibit you have in front of you prepared in the ordinary course of business?

A Yes, it was.

Q Was it the regular course of Atlantic's business to prepare such documents?

A Yes.

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MR. YOUNGWOOD: I would like to offer what has been marked as Petitioner's Exhibit 9 into evidence.

THE COURT: Any objection?

MRS. HARWERTH: No, Your Honor.

THE COURT: It will be received.

BY MR. YOUNGWOOD: (Resuming)

Q Mr. Vogel, would you describe again, as you did in connection with the three-percent discount before, on a technical basis, how did you account on your books for the sales of the singles and this ten-percent return discount?

A Again, at the time of the sale, we would bill out or invoice out the purchase at the full wholesale price, which would be an increase to sales for the full amount of the invoice, and a full increase of accounts receivable for that amount. At the end of the quarter or the end of the fiscal year, we computed the tenpercent discount that would be due to the distributors, and we made an accrual entry increasing the returns and

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allowances account, decreasing the amount due from customers on that basis.

At the beginning of the next fiscal year we again made the reversing entry, as we do with all accruals, so that when the final credit was issued, we reduced -- we increased the returns and allowances account and decreased the amount due from customer. In connection with that, when the accrual was made at the end of the fiscal year, we reduced our royalty expense and our royalty liability based on the reduction of sales that we had accrued.

Q Now, what did you do on your tax returns with respect to this ten-percent discount?

A We followed our books and decreased our sales, or increased the returns and allowances by the amount of that accrual, and at the same time decreased our royalty expense to the extent that the royalty percentage would apply.

Q Was the ten-percent return discount dependent on future purchases by a distributor?

A No, it wasn't. It was based entirely on the purchases made in the previous quarter.

Q Did a distributor get it even if he never made another purchase?

A Yes, he did, or would.

Q Was there a special reason or reasons why the

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ten-percent program was administered on a quarterly basis?

A Just administrative convenience. Also the fact that obviously we wouldn't want to handle returns on a -- more often than quarterly. This eliminated the necessity of receiving records every day.

Q You mentioned, Mr. Vogel, earlier, that Atlantic gave two-percent cash discounts to distributors. Did you account for these discounts the same way you accounted for the three-percent discount and the ten-percent discount?

A No, that was handled entirely differently. The two-percent cash discount was not issued uniformly, and it was issued only when the discount was earned, so that that entry was not made until the time the account was paid on time and the discount was earned. There were many cases where it was not.

MR. YOUNGWOOD: I have no further questions at this time. Your Honor, might I suggest, Mr. Vogel might like a little glass of water. He has been talking nonstop for --

THE COURT: Yes, let's recess for about five or ten minutes here. That will give counsel a chance to get themselves organized.

(Brief recess.)

THE COURT: You may cross examine, Mrs.

Harwerth.

MRS. HARWERTH: Thank you, Your Honor. 1 I start, I would like to make one point. I believe that 2 Mr. Vogel testified that Petitioner's Exhibits 6 and 7 3 constituted normal records prepared in the normal course of business. For the record, I would like to state that 5 Respondent contends our subpoena covered that. We stated 6 business records. I will proceed with my cross examination, 7 Your Honor. THE COURT: All right. 9 10 CROSS EXAMINATION BY MRS. HARWERTH: 11

Q Mr. Vogel, before we begin, I would like to pursue the journal entries which we have submitted to the Court as Petitioner's Exhibit -- pardon me, Respondent's Exhibit F, but before I do that, I would like you to read your affidavit dated May 29th, 1973, and before that, would you please mark this as Respondent's Exhibit G? I will give Mr. Youngwood a copy, also.

THE CLERK: Respondent's Exhibit G is marked for identification.

BY MRS. HARWERTH: (Resuming)

Q If you could just read that aloud.

A Okay. "Sheldon Vogel, being sworn, deposes that I am the senior vice president, finance, of the Atlantic Recording Corporation, a corporation organized

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under the laws of the State of Delaware, which as of December 1st, 1967, succeeded to the assets and businesses of Atlantic Record Sales Co., Inc., hereinafter referred to as Sales. During its taxable periods ended May 31st, 1967 and May 31st, 1966, I was Sales' chief accounting officer and comptroller.

"Two: For 1966, Sales claimed a deduction on its Federal income tax return for sales returns and allowances. This deduction included \$306,433 for records which had actually been returned but for which payment had not yet been made by Sales to its customers to return records and for price discounts which Sales labeled functional discounts and return privileges (the price discounts).

"Three: For 1966, the \$306,433 so deducted was determined as follows: return records, \$93,907; price discounts, functional discounts, \$45,944; return privileges, \$166,582, for a total of discounts of \$212,526, and a grand total of \$306,433."

MRS. HARWERTH: I would like to offer this into evidence at this time, as Respondent's Exhibit G.

MR. YOUNGWOOD: No objection.

THE COURT: It will be received.

BY MRS. HARWERTH: (Resuming)

Mr. Vogel, have you had an opportunity to look

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1	at Respondent's Exhibit F, sales returns and allowances?
2	A No, I haven't seen this exhibit recently.
3	Q Have you seen it at any time in the past?
4	A Well, this is my writing, so it's obviously
5	a Xerox copy of the ledger page from 1965.
, 6	Q Fine. Mr. Vogel, could you tell me what the
7	figure \$306,433.28 represents?
8	A Yes, that is the entry made increasing the sales
9	return and allowance account for the period ended May 31st,
10	1966. That figure included the figures that I just read,
ıi	the actual returns and the price discounts.
12	Q Would the \$93,907 figure be included in that
13	amount?
14	A Yes, it would.
15	Q And what would that represent?
16	A That would be the records that were actually
17	the routine returns that were actually returned and in our
18	premises at that time, but the paperwork not having been
19	processed by the closing date.
20	Q By in your premises, do you mean
21	A In the factories.
22	Q In the factories.
23	A Yes.
24	. Q What would the \$45,944 figure would that be

inclued in the \$306,000?

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Yes, it is, and that represented the threepercent album price discount. I see. Was that -- Could you explain to me how that figure was arrived at? Yes. As of May 31st, we would have simply gone to our data processing reports to compute the album -- net album purchases by our regular distributors during that period, and we simply computed the three percent of that. Which period? For the period ended May 31st, 1966. Do you mean the last quarter or the entire --Q It would be for the two months, since it's in A the middle of the calendar quarter. I see. It would be for April and May. All right, and what does the \$166,582 -- is that a component? That is also included in the \$306,000, and is the ten-percent discount that was earned for the April and May period, computed in the same way as we did the three percent. We used our data processing reports to determine the net singles purchases by the distributors for those two months, and that is the credit that we owed them.

Q What do you mean by earned?

A Meaning that based on our policy of being entitled

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to a ten-percent discount based on their net purchases during that period. Q During the last two months. Yes. All right. We are now going to Page 2 of Respondent's Exhibit F. Could you please explain to me what this figure represents, \$.99,739.22? A Yes, that would be the same entily for the -- this being for the year ending May 31st, 1967, and this would be the accrual made as of the close of that fiscal year, which again would include --11 Pardon me, I believe it is --A Begins June, sixty-six, but would end with May 31st, sixty-seven. This would include the three components of the returns not yet processed, paperwork-wise, and would include the three percent and would include the ten percent. Would the figure \$290,115 be included as a component of \$399,000? I don't know where this figure came from. I cannot tell you. I don't recognize that number offhand. Do you recognize the number \$241,000? I would

Um-hm. Yes, okay, I remember seeing this stipulation.

like to show the witness the stipulation of facts.

include the actual returns that would have been approved. So the \$109,000 would have to be the actual returns accrued as of May 31st.

Q By actual, you mean --

A Mean records that were returned, in our factory, but simply not credited on our books at that time.

Q Now, Mr. Vogel, I have turned to Page 4 of Respondent's Exhibit F. Could you please explain to me what the figure \$274,144 represents?

A This is for the period ending November, sixtyseven, and this would be the asset reserve account for the
reduction of the accounts receivable based on the tenpercent discount that was owed to the distributors at that
time.

Q What would \$182,613 represent?

A I don't know where these two numbers came from that you wrote on the side. I would have to see the --

Q This is from the stipulation of facts. Here you see \$91,531 is the balance as of November 30, 1967.

A Yes, okay. That is the -- again the sum -\$182,613, which you have written on the side, is the
portion of it that refers to the ten-percent credit. The
\$91,531 would be the amount represented by the threepercent discount, and the sum is \$274,144.

Q Mr. Vogel, for a moment let's talk about the

three-percent reserve, the three-percent credit. There 1 were no written contracts. I believe you stated that. A That is correct. 3 Q Could you explain why there were no written contracts? A It was against our policy to have written con-6 tracts with any of our distributors. They did not even 7 have written contracts establishing their licensing rights 8 within the territory that they had. So there were no contracts with regard to price, discount, territory, or anyio thing else. It was an oral agreement. It was understood 11: by everybody. 12 Q Did the distributors have any recourse against 13 Atlantic if they were not given the three-percent discount? 14 MR. YOUNGWOOD: Your Honor, excuse me. The 15 witness isn't a lawyer. 16 MRS. HARWERTH: To his knowledge. To the best . 17 18 of his knowledge. THE COURT: Are you objecting, Mr. Youngwood? 19 MR. YOUNGWOOD: Yes, I am, Your Honor. 20 THE COURT: Objection sustained. 21 BY MRS. HARWERTH: (Resuming) 2.3 To your knowledge, was any distributor ever 23 denied the three-percent discount? 24

A No, there was no distributor ever denied the

three-percent discount.

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Q On what figure was the three percent based?

A It was based on the net album purchases on a calendar quarter basis.

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Q What do you mean by net album purchases?

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A In other words, the gross purchases less the album returns that would have been made during that quarter.

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Q Returns made under the ten percent privilege?

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A . No, on the three percent we are referring only

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to the albums. There was no ten percent return privilege

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on albums. The returns were made on an exchange basis or --

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Q What do you mean by an exchange basis?

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' A Distributors were often given the privilege to

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return a given number of records and purchase an equal

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number of other records, and the sales would be recorded

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as sales, and the returns they made would simply be a

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reduction of sales.

numerous ways.

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Q So the three percent was computed on the figure after returns for defective records or returns for

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exchange were computed.

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A That's correct.

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Q I believe you stated the reason for the three percent was due to the fact that some distributors sold

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to subdistributors.

	1	. A	Well, all of our distributors did, but to
	2	you know,	varying degrees. In other words, all of our
	3	distributo	ers sold to subdistributors at one time or
	4	another.	It was part of their job.
;	5	· Q	During the taxable year in question, or both
	6	taxable ye	ears, did all of your distributors sell to sub-
	7	distributo	ors?
	8	A	Yes. Not exclusively, but they did all sell to
	9	subdistrib	outors.
	10	Q	Why would a distributor who sold to subdistri-
	11.,	butors red	quire a three-percent discount from the
	12	manufactur	rer?
	<b>i</b> 3	Α,	Because in selling to a subdistributor
1	14		MR. YOUNGWOOD: I don't think the witness ever
	15	said what	you have characterized him as saying.
	16	, ,	THE COURT: What is it, counsel?
	. 17		MRS. HARWERTH: I asked him the question.
	18		MR. YOUNGWOOD: Well, no, but you are character-
	19	izing his	testimony, and that isn't quite what he said.
	20		MRS. HARWERTH: Are you objecting?
	21		MR. YOUNGWOOD: Yes, I am.
	22		MRS. HARWERTH: I am leading a witness on cross
	23	examination	on?

MR. YOUNGWOOD: I am objecting to your characterization of his testimony.

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THE COURT: Objection overruled. Would you repeat the question again now, Mrs. Harwerth?

MRS. HARWERTH: Why would a distributor who sold to a subdistributor require a three-percent discount from the manufacturer.

THE COURT: Well, why don't you say, why would he be given --

MRS. HARWERTH: Why would he be given.

THE COURT: A three-percent discount.

THE WITNESS: The reason he would be given the discount, it was to our benefit for a distributor to sell to subdistributors, because it increased the breadth of our distribution. In other words, it would reach more final destinations. And by dealing through a subdistributor rather than dealing directly with a retailer, which was the other part of his business, he would have to sell at a lesser price. In other words, a subdistribtor would buy from the distributor at a lesser price than a retailer would buy, and therefore if he were not to get a discount for these sales to subdistributors, there would be no incentive, and in fact he couldn't make a profit by selling directly to subdistributors.

So on that basis he got what we call a functional discount.

BY MRS. HARWERTH: (Resuming)

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. Q Did your distributors ever sell forty-five's to subdistributors? By forty-five's, I mean single records.

A Yes, they did.

Q Were they afforded the three-percent discount on those sales?

A No, they were not.

Q Was the three-percent discount reflected on the invoice sent to the distributor?

A On the actual invoice?

Q On the actual invoice.

A No, it was not.

Q ' Why not?

A Well, are you asking why we billed at the full price?

Q Why was the three percent not reflected on the invoice?

A No particular reason. As I testified before, it was more convenient, and as a matter of past practice, where initially there was not a three percent, but it was computed based on the submission of duplicate invoices, and it was only a matter of carrying forward the old policy of issuing it on a quarterly basis, and at the original time it had to be done on that basis, upon receipt of the duplicate invoices. When we converted to a uniform three-percent rate, we just continued the way we were doing it. It certainly could have been done on an

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invoice-by-invoice basis. There was no reason not to.

Our computer was based on the full pricing. We saw no
reason to change it.

- Q Did payment terms vary for long playing albums?
- A As between long playing and singles?
- Q No, among long playing albums. What were the payment terms for all long playing albums?

A During the year in question, the terms were for payment split up in three payments, the first third being due ten days from the end of the month, the second third thirty days after that, and the last third sixty days from the first payment. In effect, it would stretch out over three months.

- Q This was for all long playing albums?
- A That is correct.
- Q There were no other terms of payment for long playing albums?
  - A Not with our regular distributors.
- Q All of the distributors took advantage of the thirty-sixty-ninety-day payments?
  - A To the best of my recollection.
- Q Did the terms of payment affect the threepercent discount that they were granted?
- A No, it had nothing to do with the terms of payment.

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BY MRS. HARWERTH: (Resuming)

Could a distributor obtain the three-percent 1 discount in cash if he chose? 2 Under the right circumstances, he conceivably 3 could, but it would only occur if and when a distributor were to receive a -- would be in a credit position with us . 5 at that time, and requested a check, but during this period, 6 7: I don't recall any distributor ever being in a position of where we owed him money. Once --8 THE COURT: Well, did you ever terminate any of 9 10 these distributors? THE WITNESS: Yes, we did terminate distributors. 11 THE COURT: Well, wouldn't you owe him a cash 12 13 discount then? 14 THE WITNESS: I'm sorry, I didn't hear you. 15 THE COURT: I say, wouldn't you owe him some cash then, if you terminated him? 16 17 THE WITNESS: Yes. If we terminated a distri-18 butorship, we would then possibly owe him money, 19 according to how the condition terminated. It could be 20 he -- most of the time when we terminated --21 THE COURT: You would credit that against what 22 he owed you. 23 THE WITNESS: Oh, yes. 24 THE COURT: All right.

All right. Mr. Vogel, I would like to show you 1 Petitioner's Exhibit 6, Page 2, Line 6 -- 5, pardon me. 2 It states, "Thirty-sixty-ninety days' deferred billing will 3 4 be given to qualifying accounts." Would you explain to me 5 what a qualifying account would be? 6 A A qualifying account is the way we defined any 7 regular distributor. It was simply to differentiate it 8 from a post exchange, who was not entitled to these terms, , 9 or an exporter, who would not be entitled to these split 10 datings. 11 By split datings, you mean thirty --12 Thirty-sixty-ninety, that is correct. In other 13 words, our nondistributor accounts did not get the benefit 14 of those terms. 15 Q I see. So the military --16 A Military exchanges --17 Exchanges, exporters --Q 18 A The exporters, and the mail order houses --19 Q Did not --20 Were not qualifying accounts. 21 Q I see. Did they qualify for the three percent? 22 No, they did not. A 23 On Line 6, it states, "A three-percent credit

based on net quarterly LP purchases is given to distribu-

tors." Could you define the term, net?

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Net simply means gross sales less returns. 1 All right. Mr. Vogel, let's turn now to the 2 ten percent return. I believe you stated that the ten 3 percent return privilege was granted quarterly. Could a 4 distributor take advantage of it after the quarter if he 5 so chose? 6 A Well, it always actually took place after the 7 quarter, because it would be two to three weeks after the 8 quarter was ended that we would first have the figures in , 9 order to give him his return authorization. So I don't --10 It would have to be after the quarter. 11 Q But each quarter you would have to return the 12 number of records from the return authorization. 13 A That's correct. 14 Could he wait until the end of the year and do it-15 16 No. ' 17 Q On a yearly basis? 18 No, he would lose it if he -- He would lose it if 19 he didn't do it by the end of the year, but it never 20 occurred. 21

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- Q At what point would he lose it? How long could a distributor wait before returning the records before losing the privilege for a particular quarter?
- · A We have no policy. The situation never arose.

  When the return authorizations were issued, they were

always taken advantage of within reasonable promptness,
and the credits to my knowledge were always issued, and I
don't recall a case where the issue came up that it took
four months or seven months or whatever. The issue never
came up, and we never made a decision on it.

Q When were the credits for returned records
actually reflected in Atlantic's books?

A At the time that we got the receiving report
from our factory.

Q What is the receiving report?

A It was simply an indication to us that the records were now in the house with a breakdown of which records were returned, and for the obvious reasons, we had to have that breakdown before we could issue a credit.

Q Could you explain to me why you had to have the breakdown of the records received?

A Because again one of the main purposes of the returning of the records was in order to reduce our royalty liability to artists, and we couldn't reduce that liability to a specific artist without knowing which records were returned.

Q How would that affect the credit received by the distributors?

A It would not affect it. It would simply -- It would be worded differently. In other words, the credit

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whichever records it was wouldn't matter to the distributor. It would still be the same dollar total. So it would indicate Record 2610, or 2640, but it would have no meaning to the distributor. He would just receive that dollar credit.

Q Before the records were shipped by the distributor to the factory, did the distributor have to obtain your permission?

A The permission --

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Q The permission of Atlantic? Pardon me.

A Yes, the permission was the return authorization that we sent to ..im when we first made our computation at the end of the calendar quarter.

Q Did the distributors send a list to Atlantic before mailing the records?

A Simultaneous. In other words, at the same time they shipped the records back, they sent us the packing slip. It was done at the same time.

Q In your computation of returns of records, were the ten percent return records, did they ever constitute defective records, or were those exchanged under a different policy?

A No, single defectives were included in with the regular single return.

Q Would you explain that?

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A In the case of singles, which is different from the case of albums, the defectives were not returned separately. They were returned and included amongst the return privilege. I mean, since they were being destroyed anyway, it didn't matter to us whether they were defective or whether they were usable.

Q So if you shipped a distributor 1,000 records with a scratch, he would have to use those in his ten percent return for that quarter?

A Yes.

Q He could not return the defective records to

Atlantic directly outside of the aegis of the ten-percent
return?

A Well, there could be extenuating circumstances, where a distributor would -- Again, I don't recall it happening, but certainly if a man got a large shipment of records and the entire shipment was defective, we would probably, if he had asked, taken it back without regard to the return privilege. But in the normal course of events, there is a small percentage, maybe one percent of records, that are normally defective, and these were just included with the regular returns.

Q Mr. Vogel, I would like to show you -- Mr. Vogel, one more question with regard to the three percent. What

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was the percentage of sales between the mail order houses, post exchanges and exporters in relation to what you classify as normal distributors?

I would say the normal distributors were about ninety-five percent of our business. Is that the question you had? And the miscellaneous accounts would maybe represent five percent.

Now, Mr. Vogel, on invoices for LP sales, how did you reflect the terms of payment?

With regard to the cash terms, it was indicated on the top of the invoice. There was a space for terms, and it would simply be marked in there, thirty-sixtyninety, and those terms were understood in the trade to mean what I explained.

Did it appear anywhere else on the invoice?

The invoice itself, at the bottom, I believe --We had different computers, and I'm not sure whether that took place this year, but during the year when we received a new computer we actually split out the total dollars of the invoice, and showed it in the thirds so the distributor would automatically know what the third of his invoice came to.

Did you --Q

. A It also made it -- excuse me. It also made it easier for posting. On his accounts receivable, we would

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make three postings rather than one, so that as the payments came in, it would be easier to tick off the items paid.

Q So that the breakdown was reflected in the posting on your --

A Yes, it was.

Q Mr. Vogel, I have here a computer print-out for the period ended 5/31/67, listing returns received by Atlantic from the distributors.

I would like to, I suppose, have this entire document -- I can't see how we can Xerox pages this big -- submitted into evidence, and marked as Respondent's Exhibit H.

MR. YOUNGWOOD: Objection, Your Honor. I have no idea what it is, and it hasn't been testified to by any witness.

MRS. HARWERTH: I am marking it for identification

MR. YOUNGWOOD: Excuse me. I thought you were

submitting it into evidence.

MRS. HARWERTH: Yes, marked for identification.

THE CLERK: Respondent's Exhibit H is marked for identification.

BY MRS. HARWERTH: (Resuming)

Q. Mr. Vogel, can you identify --

MR. YOUNGWOOD: Excuse me. I would like to see

1	a copy of that, please.
2	MRS. HARWERTH: This is the only copy.
3	MR. YOUNGWOOD: Then I would like to look at it
4	while you do.
5	MRS. HARWERTH: All right, we will look at it
6	together.
7	THE COURT: I think, counsel, if you will let
8	Mrs. Harwerth ask her questions, and then when she offers
9	it, before it will be admitted, you will be permitted to
10	look at it.
11	. '. MR. YOUNGWOOD: Your Honor, I would like to, if
12	I could, look at it so that I might have an opportunity if
13	appropriate to object to questions.
14	MRS. HARWERTH: Your Honor, this document was
15	given to me pursuant to subpoena by Petitioner.
16	THE COURT: I assume all the counsel is doing
17	now is having the witness identify it. Is that right?
18	MRS. HARWERTH: Yes, Your Honor.
19	THE COURT: All right. Sit down, please.
20	BY MRS. HARWERTH: (Resuming)
21	Q Mr. Vogel, do you recognize this book and the
22	documents contained in it?
23	A Yes. Yes, I do recognize it.
24	. Q All right. Would you tell the Court what it is?
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This is our distributor print-out which we

received every month, and indicates a breakdown by distributor and by all customers of their purchases for the month, for the quarter to date and for the year to date, broken down between singles, albums, and further broken down between gross, returns and net.

MRS. HARWERTH: All right.

THE COURT: Now, are you offering that, counsel?

MRS. HARWERTH: Yes, I would like to offer this into evidence.

THE COURT: Let Mr. Youngwood see it, and see if he has any objection.

MR. YOUNGWOOD: Are you offering the whole book, or really only the page that is open?

MRS. HARWERTH: I am going to offer the whole book.

MR. YOUNGWOOD: For the record, what is being offered into evidence is apparently a record which covers, so far as I can see, a twelve-month period in 1967. I have no objection.

THE COURT: It will be received.

BY MRS. HARWERTH: (Resuming)

Q All right, Mr. Vogel, if you will look with me at the first line, could you read me the number and the name beside it, and explain it?

A Thirteen-sixty would simply be an account number

for the distributor. Schwartz Brothers would be the name of the distributor involved.

Q All right.

THE COURT: Now, that is the first line of what page, counsel?

MRS. HARWERTH: The first line of -- I'm sorry,
Your Honor, these pages are not numbered. This is for the
month ending May 31, 1967.

THE COURT: Very good.

BY MRS. HARWERTH: (Resuming)

Q Looking to the far right of that page, could you explain to the Court what the term, gross -- it states, year to date, gross, returns, and net. What do those --

A These are rounded off to the nearest dollar, and it is a summary for that distributor of the gross dollar sales, which would be simply the total of the invoices to that distributor. The returns would be the total of the dollar credit memorandums issued to that distributor, and the net would simply be the difference between the two. There is one line there for singles, and there's one line for albums, and a total line.

Q Could you explain to the Court --

MR. YOUNGWOOD: Excuse me. Your Honor, it is impossible for me to follow what the witness is doing.

May I go and look at the document while the witness is

testifying?

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THE COURT: We'll let you have it when the witness finishes, counsel.

BY MRS. HARWERTH: (Resuming)

Q Could you explain which line is for long playing albums and which line is for singles?

A Yes, the line with the X on it is singles.

Q I see. All right. And the line below it --

A Is albums, and the third line is the total.

Q Now, in returns under the Account 1360, Schwartz Brothers, for year to date, on singles --

A 'Um-hm.

Q Could you read that -- those numbers to the Court and explain them?

A Yes. The gross sales were \$210,980 for the five months. The returns were \$33,072, and the net singles business was \$177,908.

Q How was the \$33,072 computed?

A It was simply a computer addition of the total credit memorandums for singles issued to Schwartz Brothers.

Q By total credit memorandum, what do you mean?

A The total of the credit documents that were issued to that distributor during the year. For singles.

Again, we separated these between singles and albums.

Q Would that include the ten percent?

Q Can you explain to the Court why the total returns figure exceeds the gross sales figure for that period, the year to date?

Why the returns exceed the --

Or, pardon me, why it exceeds ten percent.

Well, the distributor made many returns, approximately \$12,000 worth, over and above the return privilege that he was granted.

• Q How would you account for these returns over and above the return privilege, if the defective records were included in the ten percent return privilege?

How would we account for them?

Right, the \$12,000 over and above the ten percent to which he was entitled.

I'm not sure I understand what you're asking, as far as the question.

All right. If ten percent of \$210,980 would be, say, approximately \$22,000 -- ...

Right.

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. Q How come the distributor was granted \$33,000 in credit for that period?

A The distributor must have had surplus singles on hand over and above what he returned on the return privilege, and no doubt requested additional returns, which we would have granted, based on the numbers here.

- Q Was this often the case?
- A Very often.
- Q Did all distributors return more than ten percent?

A I wouldn't say all, but many did, but in any case, any returns they would make over and above the ten percent had to have special permission, which we would grant only based on our relationship with that distributor.

Q Could any of the amount for ten percent be for returns for previous quarters?

A Well, this -- this figure you are pointing to is for a five-month period, so it would certainly include two different return privileges. It also would include, since this is the five months ending May 31st, it would also include the credit that was issued in January, which would have been based on the December, 1966, return privilege.

Q All right. Well, let's move over then to the quarter to date.

A Um-hm.

Q Take a look at that. Would you read those amounts

to the Court for the singles?

A Yes, the gross sales, \$116,281, the returns, \$16,209, net sales, \$100,072.

Q What would ten percent of gross --

A \$11,628.

Q Can you account for the additional \$5,000 in returns for the quarter?

A Well, there would be no relationship. The return that was issued during the two months, April and May, would be the return based on the sales for the March quarter, because the return was credited in the month following the quarter. So this would include the April credit, which would have been based on March sales. It would have no bearing on the April-May sales. Also, this credit, the return privilege would obviously cover a three-month period from the prior quarter, and the gross sales there are for two months.

Q I am turning to the back page of the page which
I was looking at before, at the far righthand side of the
page. Could you explain the figures listed under
the column lageled, Year to Date Gross?

MR. YOUNGWOOD: Excuse me. Would you identify again which page that is?

MRS. HARWERTH: The page that faces the back page of the page I was discussing previously.

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THE WITNESS: It's the end of that particular report. Which line do you want me to read? The singles line. Gross sales, \$3,219,763, returns, \$387,055, net sales, \$2,832,708. BY MRS. HARWERTH: (Resuming) All right. Could you explain to the Court what 6. this line represents, long playing or singles? That is the line for the singles for the fivemonth period. Singles for the five-month period. Right. All right. What would be ten percent of the total amount of singles? \$322,000. Could you read again to the Court what that --The returns actually were \$387,000. All right. By what amount did that exceed ten Q. percent? A \$65,000. Can you account for that? A Well, again, it is unrelated, because during the January period, the returns would have been made based on the prior quarter, and those returns are reflected in that \$387,000, and there is no reason why it would relate necessarily to the sales for this year. So to the

extent that there is always a one quarter lag in the issuing of the credits, there is never any necessary relationship there.

Q By one quarter lag, what do you mean?

A In other words, the business for the December quarter, the credits are issued in January. The business for the March quarter, the credit would be reflected in April, when we had our data processing report and could issue the return authorization. So that you are talking about sales for five months, and returns which do not include the returns for the last two months, but do include the returns for the October, November, December, 1966 period.

Also, as I said before, there could be other returns in there, certainly, during the course of the five months.

Q All right. I am turning back to the first page that I was discussing. On the far righthand side of the page there are penciled figures beside each line. Could you explain those penciled figures to the Court?

A Yes. Manually, we would compute each distributor's percentage of our nationwide business within the label. For example, this is on the Atlantic report. There is another report for Atco. You will notice that those figures totaled approximately 100 percent

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for singles, 100 percent for albums, and 100 percent in total, and in this case Schwartz was 6.4 percent of our singles business for the Atlantic account, and was 7.3 percent of our album business.

Q Six-point-four percent --

A Of our total singles business in the Atlantic label.

Q In the United States.

A Yes.

MRS. HARWERTH: All right. Your Honor, this is the only copy, so I will leave it at the stand.

Your Honor, Respondent has no further questions for the witness at this time.

THE COURT: Any redirect, Mr. Youngwood?

MR. YOUNGWOOD: One mcment, Your Honor.

(Pause.)

REDIRECT EXAMINATION

BY MR. YOUNGWOOD:

Q Yes, Your Honor, I have, I think, just a couple of very brief questions.

Mr. Vogel, there was some discussion in your cross empirical with respect to the three-percent discount, and addistributors, and why you gave it to them.

During 1966 and 1967, did every one of the forty-one regular distributors get a three-percent credit on all LP

purchases without proof and whether or not that distributor resold all or any portion of those records to a subdistributor?

Yes. They all did receive that credit, yes.

All right. And was the receipt of that credit dependent upon what they did with the records?

No, we required no evidence, and were not interested. It was simply given uniformly.

So that the three-percent credit was automatically granted on the total dollar net purchases?

Yes, that is correct.

With respect to your credit policy, I believe you were asked whether everybody took advantage of the thirtysixty-ninety-day provisions, and it was a little unclear to me as to what that was all about. When you id everybody took advantage of it, what did you mean?

Well, I meant that nobody would pay the invoice in full in March if they were able to obtain their cash discount by paying over a three-month period. There would be no reason to pay the invoice in advance.

Did everybody always get the cash discount?

No, only when they paid their invoice according to the terms.

Did everybody always pay their invoice in accordance with the terms?

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No, they did not. 1 MR. YOUNGWOOD: I have no further questions. THE COURT: Sometimes they took it anyway, :3 though, didn't they? 4 THE WITNESS: Excuse me? THE COURT: I say, sometimes they take it anyway, don't they? THE WITNESS: We fought with them. 8 THE COURT: That's right. All right. 9 RECROSS EXAMINATION 10 BY MRS. HARWERTH: 11 .. 12 Q One question. Would Atlantic retain a distributor that did not sell to subdistributors? 13 14 A Yes, we -- Well, again, the decision never did 15 come up. To my knowledge, everyone did, so the question 16 never came up, if he refused, what we would do. It was 17 to all of our benefit that he did, and it was just done, 18 and it was part of the distributor's job, and it was 19 necessary for us and it was necessary for him. 20 When you took on a new distributor, did you 21

make it clear that the three percent was because of the sale to subdistributors?

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No. It was simply indicated that this was our normal functional discount that he would receive, and it was never connected or indicated to him that it was

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necessary to deal with subdistributors to obtain this discount.

MRS. HARWERTH: Thank you.

THE COURT: You may be excused.

(Witness excused.)

MR. YOUNGWOOD: Your Honor, I would like to call as the Petitioner's next witness Mr. Leonard Rakliff. Mr. Rakliff?

THE CLERK: You do solemnly swear the testimony you are about to give to the Court in this case shall be the truth, the whole truth, and nothing but the truth. so help you God?

THE WITNESS: I do.

THE CLERK: Please be seated. Would you state your name and address for the record, please?

THE WITNESS: Leonard Rakliff, 919 North Board Street, Philadelphia, Pa.

L E O N A R D R A K L I F F, called as a witness, having been duly sworn, took the stand, was examined, and testified as follows:

DIRECT EXAMINATION

BY MR. YOUNGWOOD:

For the record, Mr. Rakliff spells his last name R-a-k-1-i-f-f.

Mr. Rakliff, by whom are you employed, and what

1	is your position?
2	A Universal Record Distributors. I am general
3	manager.
4	Q Where is Universal Record Distributors, sir?
5	A In Philadelphia, Pennsylvania.
6	Q How long have you been employed by Universal?
7	A Since September, 1962.
8	Q And by whom were you employed prior to that time?
9	A J was employed by another distributor, which
19	was J. & Sparks, Distributors, in Philadelphia, from
11	1946.to sixty-two.
12	Q Would you describe the principal business of
13	your employer, Universal?
14	S A A A A A A A A A A A A A A A A A A A
15	them by promoting them by radio stations and putting them
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•2	Q In 1966 and 1967, did Universal buy singles and

albums from Atlantic Record Sales?

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. A Yes, we did.

Q Did you personally deal with Atlantic?

A Yes.

Q With reference to Universal's purchase of records from Atlantic, are you familiar with the term, three-percent functional discount?

A Yes, I am.

Q Could you tell the Court what it was?

A It was a discount that we got on our purchases of LP's. It originally started with a lot of paperwork where we got a five percent credit against all our sales to subdistributors, and to alleviate the paperwork, they gave us the three-percent functional discount.

Q Was that -- That three percent was given to Universal?

A Yes.

Q Was Universal notified at the time the old system, the five-percent system, was replaced by the flat three percent discount on all albums?

A Yes, we got a letter on it.

Q If I might have Exhibit 7, please.

Mr. Rakliff, I hand to you our Petitioner's

Exhibit 7, and I will ask you to look at it and tell me

if you have seen it or materials like it before.

A Well, this is the Atlantic booklet, and I was

a distributor for Atco records. 1 Q . Oh, thank you. May I have Exhibit 6? 2 3 I show you Exhibit 6. Will you tell me if you have seen that before, or materials like it before. Yes, I have seen this before, and others like it. 5 6 Under what circumstances would you have occasion 7 to see that brochure? 8 . A At every sales meeting where they had a promotion 9 with extra discounts, and promotions, these booklets were 10 made up and given to us. 11 Q Mr. Rakliff, the three-percent discount we are 12 talking about, was this granted on your purchases of LP's 13 in 1966 and 1967? 14 Yes, it was. 15 Did you know when you placed an order and when 16 you got the LP's that you were going to be entitled to 17 this, that you were going to be getting this? 18 Yes. In fact, we based our sales price to our 19 customers on the three percent. 20 Did you get the three percent on all of your 21 purchases of LP's? 22 Yes, we did. 23 Let me switch subjects if I could at this point 24 and go to the question of singles. With reference to 25 Universal's purchase of records from Atlantic, are you

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familiar with the term, ten percent return privilege? 1 Yes, I am. 2 Could you explain what that term means to you? 3 4 Yes, we got a ten-percent return on all our purchases of single records for the quarterly period. 5 How did it work, really? How did the program work? 6 Whatever we bought from, say, January to the end 7 of March, in a dollar figure, they forwarded us a return 8 authorization giving us a given amount that we were allowed 9 to return, which was ten percent of our total purchases. 10 We made a list of records that we were returning, sent it 11 off to the factory, and sent a copy of the packing slip to 12 the main office. 13 14 Did you always have on hand enough singles to return to meet the program? 15 16 · We always met the program. 17 Well, but did you ever have to go out and buy 18 some singles because you didn't have them, or --19 On occasion. On occasion, we might have purchased some records from rack jobbers or people that dealt 20 21 in distress merchandise. 22 So, in other words, you didn't have enough 23 records that you had bought yourself, so you had to go out and find them someplace else?

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Right.

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Q Did you do this with any degree of frequency?

A On occasion it could have been as high as fifty

percent. Sometimes it might have been twenty-five percent,

and other times there might not have been any.

Q Again, just for the record, we are talking here again about the 1966-1967 period. Do you understand that?

A Yes.

Q Was there ever a time in either 1966 or 1967 or otherwise that Universal did not get the full ten percent credit?

A No, we always met the ten-percent return.

Q 'Did you ever return singles in excess of that automatic amount?

A Yes, we did. On occasion, we were overstocked on other records that we got an extra ten -- we got an extra return, and also there were programs where we were entitled to an extra return of singles on our purchases of LP's.

Q If you wanted to return some extras, what did you do?

A Well, we went up there and negotiated a return.

Q I have no further questions at this time. Excuse me. Yes, I'm sorry. Just, I guess, one other question.

When you would go out and buy some of these records on the outside, what did you pay for them?

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A It could have been anywhere between five and fifteen cents.

Q And what was the credit that Atlantic would give you?

A Thirty-eight-and-a-half cents.

MR. YOUNGWOOD: Thank you.

THE COURT: You may examine, Mrs. Harwerth.

CROSS EXAMINATION

BY MRS. HARWERTH:

Q Thank you.

Mr. Rakliff, I believe we spoke on the phone once before.

A Yes, we did.

Q So I don't have to introduce myself to you.

A Right.

Q What would Universal have done if it had stopped getting the three-percent discount from Atlantic?

A We would have to raise our prices to our customers.

Q To the best of your knowledge, would Universal have sued Atlantic?

MR. YOUNGWOOD: Excuse me. I mean, counsel is asking the witness to speculate.

THE COURT: Objection sustained.

BY MRS. HARWERTH: (Resuming)

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Q Did you ever know a distributor in the business that sued Atlantic because of a revocation of a credit?

A Not to my knowledge, no.

Q Let's talk a little bit about the mechanics of the ten-percent return privilege. Could you explain to the Court in detail how you would go about returning records to Atlantic under this program?

A Well, in detail, we got the amount and the authorization from Atlantic --

Q Okay. Well, let's fix a point in time for that.

A All right.

Q When would you receive that? How many days after the quarter?

A We'd get it probably by the 15th of the following month.

Q All right.

A We'd go to our warehouse and get a listing of the amount of records that we had, and box them up, and just return them.

Q About how long would that take, going to the warehouse, boxing them up?

A After we got the authorization, it was generally out within seven to ten days.

When did you receive the credit? When did you actually receive the credit?

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1	A Oh, a couple of weeks later, after the return
2	was made.
3	Q And how is this reflected. Did they send you a
4	A A credit memo.
5	Q A credit memo.
6	A Um-hm.
7,	THE COURT: But wouldn't you actually take the
8	credit when you shipped it?
ġ	THE WITNESS: Would we actually take the credit?
10 .	No.
11	THE COURT: You wouldn't. Oh, that's right.
12	You still owed them money anyway on this account.
13	THE WITNESS: Right.
14	BY MRS. HARWERTH: (Resuming)
15	Q When you had to go out and purchase additional
16	singles to meet the ten percent return privilege, did you
17	purchase only Atlantic or Atlantic related company singles,
18	or did you purchase anything?
19	A No, it was just Atlantic. That was the only
20	thing we were allowed to return to them.
21	Q The Atlantic labels that had been shipped to you.
22	A Right.
23	Q Atlantic had many labels. Am I correct
24	A Yes, um-hm.
25	· Q If there was a particularly risky album or

forty-five, in the sense that it was not a well known artist, or speculative, did Atlantic provide for any special deals to the distributors for distributing such a record?

A No, the albums were on a 100 percent exchange basis, and we bought what we thought, you know, as we felt that we were going to be able to sell them.

Q So you would not have a greater return privilege on singles that were risky?

A No. All singles are risky.

Q Particularly now, huh? Mr. Rakliff, I would like to show you Petitioner's Exhibit 9. It is the invoice.

A Um-hm.

Q It states, final sale, no merchandise returnable without written authorization from this office. What does that mean to you? Do you see it? It's awfully fine print.

A Yes. It means that we have to have a written authorization to return any merchandise to them, and there is a ten percent quarterly return privilege that we are entitled to.

Q So that to return any merchandise, including the ten percent, you had to have written authorization --

A Right.

Q From Atlantic.

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Q Did you ever return any records to them without written authorization?

A No.

MRS. HARWERTH: We have no other questions at this time, Your Honor.

REDIRECT EXAMINATION

BY MR. YOUNGWOOD:

Q Your Honor, I just have one further questions.

Mr. Rakliff, you were asked whether or not you

ever knew that a distributor -- whether a distributor ever sued Atlantic because it didn't get its three-percent credit, and you answered that you didn't know of anybody who did. Did you ever know of an exhibitor to your knowledge

who didn't get the three-percent credit?

A No, I didn't.

MR. YOUNGWOOD: I have no further questions.

THE COURT: You may be excused.

(Witness excused.) .

MR. YOUNGWOOD: Your Honor, the Petitioners rest. We have no further witnesses.

THE COURT: Does the Respondent have any?

MRS. HARWERTH: The Respondent rests.

THE COURT: All right. We will give the brief dates, here.

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1	(Comments off the record.)
2	MR. YOUNGWOOD: You Honor, in terms of briefs,
3	we would prefer ninety days, really just because of
4	vacations.
5	THE COURT: Well, let's start out under the
6	rules, and then the parties can apply for an extension.
7:	MR. YOUNGWOOD: That is forty-five?
8	MRS. HARWERTH: Well
9	MR. YOUNGWOOD: It is forty-five under the rules
10	MRS. HARWERTH: Respondent would like to ask for
11	sixty.
12	MR. YOUNGWOOD: Well, Your Honor
13	THE COURT: Well, file a joint motion after
14	about thirty days, because
15	MR. YOUNGWOOD: Your Honor, so
16	THE COURT: I have a problem with varying too
17	much from our rules.
18	MR. YOUNGWOOD: So, Your Honor, what is your
19	pleasure with respect to briefs?
20	THE COURT: Let's see. Really, ninety days
21	sort of shocks me, frankly.
22	MR. YOUNGWOOD: Well, let me tell you what
23	I must say that if ninety days would shock you, I would
24	prefer to leave it at forty-five, because

THE COURT: You would?

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MR. YOUNGWOOD: Frankly, between forty-five and 1 seventy-five, I don't expect to be in the vicinity, so --2 THE COURT: I see. Well, I would be glad to 3 take it without briefs, if you want to submit it on that 4 basis. 5 MR. YOUNGWOOD: No, I would like a shot, Judge, 6 at -- and I would assume the Respondent would, too. 7 THE COURT: I think I have briefed this thing myself at one time. Well, let's go ahead and put it --9 When does ninety days take us to? Goodness. 10 THE CLERK: Ninety days is September 11th. 11 THE COURT: And then the replies would be due 12 October --13 THE CLERK: Eleventh. 14 THE COURT: Eleven. All right. Let's go ahead 15 and put it on that basis. 16 MR. YOUNGWOOD: Thank you, Your Honor. 17 THE COURT: This division is running out of work, 18 gentlemen. I don't know --19 MR. GOLDBERG: Your Honor, is your copy of 20 Exhibit F legible? 21 THE COURT: I believe it is. Well, we have the 22 originals, anyway, so --23 MR. GOLDBERG: That's that sales brochure. 24 THE COURT: Yes. Yes, Exhibit F is this --25

MR. GOLDBERG: F, Your Honor, is the -THE COURT: It's this stuff, isn't it? Oh, no
that's right. Exhibit F -- It is, yes. Yes, I can
identify the figures that are there.

MR. GOLDBERG: All right, fine.

THE COURT: Right. Well, thank you, gentlemen.

MR. YOUNGWOOD: Thank you.

MR. GOLDBERG: Thank you, Your Honor.

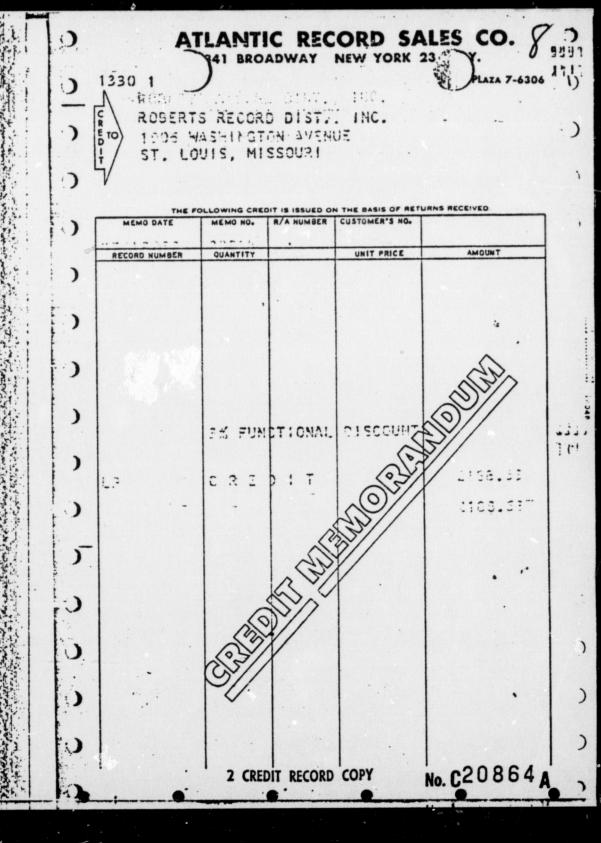
(Whereupon, at twelve o'clock noon, the case was concluded as described above, and the Court was recessed until one o'clock p.m. of the same day.)



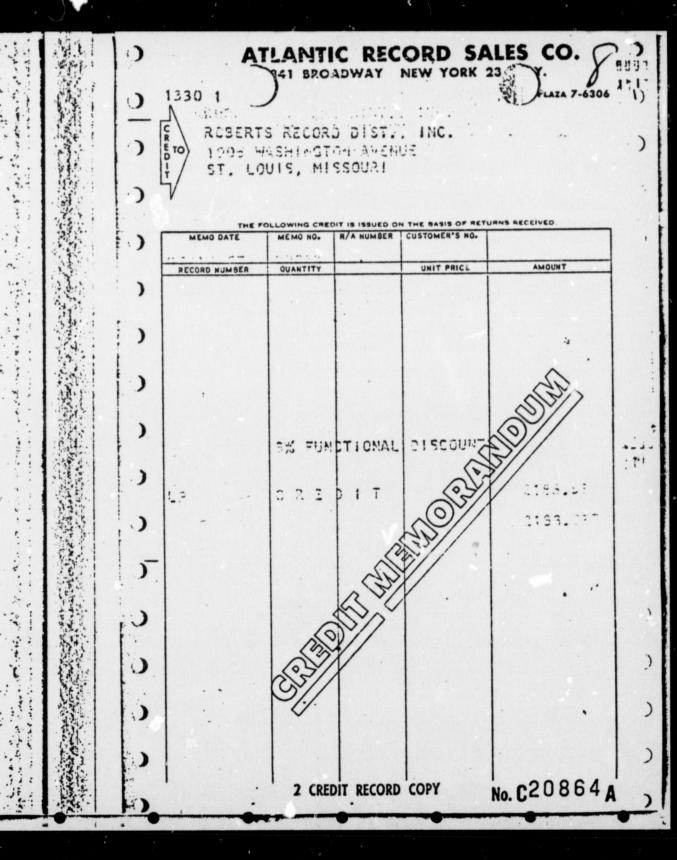
ATLANTIC RECORD SALES CO. 1330 1 ROBERTS RECORD DIST. INC. 1995 MASH : MGTON AVENUE ST. LOUIS, MISSOUR! THE FOLLOWING CREDIT IS ISSUED ON THE BASIS OF RETURNS RECEIVED. R/A NUMBER | CUSTOMER'S NO. RECORD NUMBER QUANTITY UNIT PRICE AMOUNT DISCOUNT, 3% FUNCTIONAL 171 : 3 = No. C20864 2 CREDIT RECORD COPY

[Exhibit 8]

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No 66893 AD

ATL. TIC RECORD SALES CO. NC.

PLAZA - 7-6306

0 TO F & F ENTERPRISES, INC. 2704 FREEDOM DRIVE CHARLOTTE, NORTH CAROLINA

NOTE
All claims for credit due within 5 days from of invoice or claim will not be allowed. Make all claims for breakage

FINAL SALE .. NO MERCHANDISE RETURNABLE WITHOUT WRITTEN AUTHORIZATION FROM THIS OFFICE

10% QUARTERLY BETURN PRIVILEGE BASED ON NET PAID SALES OF "SINGLES" 45 8PM 2 SIDES

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JUN 4 1973

In the Matter of:

NORTH-ATLANTIC REGION

Ahmet Ertegun and Ioana Ertegun v. Commissioner of Internal Revenue Docket No. 3830-71

Nesuhi Ertegun and Belkis Ertegun v. Commissioner of Internal Revenue Docket No. 3868-71

Gerald Wexler and Shirley Wexler v.
Commissioner of Internal Revenue
Docket No. 3831-71

#### AFFIDAVIT

STATE OF NEW YORK )
COUNTY OF NEW YORK )

SHELDON VOGEL, being sworn, deposes and says:

1. I am the Senior Vice-President, Finance, of the Atlantic Recording Corporation, a corporation organized under the laws of the State of Delaware, which, as of December 1, 1967 succeeded to the assets and businesses of Atlantic Record Sales Co., Inc. (hereinafter referred to as "Sales"). During its taxable periods ended May 31, 1967 ("1967"), and May 31, 1966 ("1966"), I was Sales' chief accounting officer and

#### Controller

2. For 1966, Sales claimed a deduction on its

Pederal income tax return for sales returns and allowances.

This deduction included \$306,433 for records which had actually been returned but for which payment had not yet been made by Sales to its customers (the "returned records") and for price discounts, which Sales labelled functional discounts and return privileges (the "price discounts").

3. For 1966, the \$306,433 so deducted was determined as follows:

Returned Records

\$ 93,907

Price Discounts:
Functional Discounts \$ 45,944
Return Privileges \$166,582

\$306,433

Sworn to before me this

29th day of May , 1973.

Notary Public, State of New York
No. 30.2343350
Qualified in Nassau County
Commission Expires March 30, 19.1.

T. C. Memo. 1975-27

#### UNITED STATES TAX COURT

AHMET ERTEGUN and IOANA ERTEGUN, Et al.,  $^{1}$  Petitioners  $\underline{v}$ . COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 3830-71, 3831-71, 3868-71, 3908-71.

Filed February 13, 1975.

Alfred D. Youngwood, Mark M. Weinstein, and George P. Felleman, for the petitioners.

Stanley Goldberg and E. Noel Harwerth, for the respondent.

The cases of the following petitioners are consolidated herewith: Gerald Wexler and Shirley Wexler, docket No. 3831-71; Nesuhi Ertegun and Belkis Ertegun, docket No. 3868-71; and Atlantic Record Sales Co., Inc., docket No. 3908-71.

### MEMORANDUM FINDINGS OF FACT AND OPINION

QUEALY, <u>Judge</u>: Respondent determined deficiencies in the income tax of petitioners in the following amounts:

Docket No.	Petitioner	Taxable Year and Period	Deficiency
3830-71	Ahmet Ertegun and Ioana Ertegun	1967	\$ 79,273.43
3831-71	Gerald Wexler and Shirley Wexler	1967	66,235.02
3868-71	Nesuhi Ertegun and Belkis Ertegun	1967	44,290.81
3908-71	Atlantic Records Sales Co., Inc.	6/1/67 to 11/30/67	19,023.39
•			\$208,822.65

As a result of concessions by the parties, the sole issue for our determination is whether for the fiscal year ended May 31, 1967, Atlantic Records Sales Co., Inc. (hereinafter "Atlantic") is entitled to accrue, either as an offset against gross sales pursuant to section 451<sup>2</sup> or as a deduction from gross income pursuant to section 461, a 10 percent record return allowance permitted on sales of single records to its regular distributors.

The resolution of such question as to Atlantic, a duly elected subchapter S corporation under section 1372,

All statutory references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

for its fiscal year ended May 31, 1967, shall be determinative of whether the individual petitioners, who were shareholders therein for such period, are entitled to account for such accrual in computing their respective shares of the corporation's "undistributed taxable income" for such period.

If we find that Atlantic is not entitled to accrue such allowance for the period in question, either as an offset to gross sales or as a deduction from gross income, an appropriate adjustment will be made in the taxable income of Atlantic for the taxable period ended November 30, 1967.

#### FINDINGS OF FACT

Some of the facts have been stipulated. Such stipulations and the exhibits attached thereto are incorporated herein by this reference.

Petitioners in docket No. 3830-71 are Ahmet Ertegun and Ioana Ertegun, husband and wife, whose legal residence at the time of the filing of the petition herein was New York, New York. They filed a timely joint Federal income tax return for the taxable year 1967 with the district director of internal revenue, Manhattan District, New York.

Petitioners in docket No. 3831-71 are Gerald Wexler and Shirley Wexler, husband and wife, whose legal residence at the time of the filing of the petition herein was East Marion, New York. They timely filed their joint Federal income tax return for the taxable year 1967 with the district director of internal revenue, Brooklyn District, New York.

Petitioners in docket No. 3868-71 are Nesuhi
Ertegun and Belkis Ertegun, husband and wife, whose
legal residence at the time of the filing of the
petition herein was New York, New York. They timely
filed their joint Federal income tax return for the
taxable year 1967 with the district director of
internal revenue, Manhattan District, New York.

Ioana Ertegun, Shirley Wexler, and Belkis
Ertegun are petitioners in their respective cases
solely by reason of their filing joint Federal income
tax returns for the calendar year 1967 with their respective
husbands. All subsequent references to "individual
petitioners" shall refer to Ahmet Ertegun, Gerald Wexler,
and Nesuhi Ertegun, collectively.

- 5 -

Petitioner in docket No. 3908-71 is Atlantic, a corporation organized under the laws of the State of New York and having its principal place of business in New York, New York. During the period in question, Atlantic was a duly elected subchapter S corporation under section 1372 through its fiscal year ended May 31, 1967. It was dissolved on December 1, 1967. Atlantic filed a Federal U. S. Small Business Corporation income tax return for the taxable year ended May 31, 1967 and a regular Federal corporate income tax return for the taxable period ended November 30, 1967 with the district director of internal revenue, Manhattan District, New York. Atlantic was on the accrual method of accounting for Federal income tax purposes.

At all times pertinent herein, Atlantic had 8,872 shares of common stock issued and outstanding. Individual petitioners Ahmet Ertegun, Gerald Wexler, and Nesuhi Ertegun collectively owned all of such stock in the amounts of 3,741 shares, 2,957 shares, and 2,174 shares, respectively.3

In terms of percentage, the stock ownership of the individual petitioners in Atlantic was 42.17 percent, 33.33 percent, and 24.50 percent, respectively.

- 6 -

As of November 30, 1967, the individual petitioners had sold all of their Atlantic common stock to Atlantic Recording Corp., a corporation organized under the laws of the State of Delaware, and a member of an "affiliated group" of corporations of which Warner Bros.-Seven Arts, Inc., was the "common parent" as defined in section 1504. As of such time, Atlantic's election as a small business corporation terminated pursuant to section 1372(e)(3).

Atlantic was engaged in the business of selling phonograph records at wholesale, consisting of both 45 rpm singles (hereinafter sometimes referred to as "singles") and 33 rpm albums (hereinafter referred to as "albums"). Atlantic sold regularly only to approximately 58 distributors, 41 of whom were considered to be its "regular distributors." The remaining 17 distributors were post exchanges, mail order houses and exporters.

During the period in question, Atlantic granted to its "regular" distributors a 3 percent discount on the sales price of albums. The customers who were mail order houses, military post exchanges or exporters did not receive the reduction.

The 3 percent discount was based on the amount of net purchases made by the distributors for each calendar quarter and was granted prior to the invoices being paid in full. The credits based on the 3 percent discount were issued to distributors 2 to 3 weeks after the end of such period and were used to offset the next remittance. The discount was not dependent on any future purchases nor was any future action on the part of the distributors required.

In addition to the 3 percent discount on album
""" purchases, Atlantic also granted its regular distributors
a 10 percent record return allowance on the purchases
of single records. The invoice on the sales of singles
stated that no merchandise was returnable "without written
authorization from this office."

The amount of singles a distributor was permitted to return under the 10 percent allowance was computed at the end of each calendar quarter and was based upon the net purchases of single records during such period. The authorization for the return of the records was then issued, generally within 2 to 3 weeks after the end of the quarter. The singles returned by the distributors were sent directly to Atlantic's factory, at which

time the company would issue a credit memorandum for use against future remittances.

The 10 percent allowance enabled the distributors to obtain a full rebate up to the 10 percent limit on those singles which were worthless or could not be sold. The benefit of the allowance to Atlantic was that it effected a reduction in its net sales to distributors, a figure which was used to determine royalty payments to its recording artists. The returned singles were generally scrapped by Atlantic.

72 ...

If a distributor wanted to return more singles than permitted by the quarterly authorization, he would have to negotiate the return of the excess singles with Atlantic. In the event that a customer did not have enough single records on hand to take full advantage of the return allowance, he was allowed to purchase singles with Atlantic labels from jobbers and use them for purposes of the return allowance. 4

The singles returned by the distributors did not have to be records purchased in the period to which the 10 percent allowance would apply. No attempt was made by Atlantic to coordinate the records returned with the individual

Single records purchased from jobbers would cost the distributor between 5 and 15 cents each. He would then return the records to Atlantic for a credit of 38.5 cents each, the regular wholesale price of a single.

purchases by its regular distributors.

On purchase of singles, the entire amount of the invoice would be due on the tenth day of the month following the month of purchase. Atlantic provided for a 2 percent cash discount for prompt payment of bills. Atlantic did not reduce its sales by the amount of this discount until such time as the payments were timely made and the discount earned. 5

On its books, Atlantic accounted for the sale of its singles and the 10 percent return allowance on such sales in the following manner. At the time of the sale, the full invoice price of the records was debited to its accounts receivable and credited to its sales account.

At the end of the quarter or fiscal period, Atlantic computed the 10 percent allowance due its distributors and made an accrual entry to its sales returns and allowances account to that extent. The company simultaneously made entries reducing its royalty expense based on such accrual.

As of the first day of the next quarter or fiscal

The same 2 percent cash discount was equally applicable to the purchase of albums. Atlantic had a 30-60-90 day payment plan in effect for its albums, with the initial payment due on the tenth day of the month following the month of purchase.

period, Atlantic credited its sales returns and allowances account and debited its accounts receivable in the above amount, thereby reversing the prior accrual entry. When the credit memorandums were subsequently issued to the distributors reflecting receipt of the single records at its factory, Atlantic debited its return and allowances account again and reduced its accounts receivable to that extent. The same procedure was followed by Atlantic with respect to its 3 percent discount.

As of its fiscal year ended May 31, 1967, Atlantic had a debit balance in its returns and allowances account with respect to its 3 percent discount and 10 percent allowance in the amounts of \$48,531 and \$241,584, respectively. These balances represented discounts or allowances on purchases by distributors in April and May of 1967. On June 1, 1967, Atlantic made reversing entries of the above debit balances.

On their respective joint Federal income tax returns for the calendar year 1967, the individual petitioners included in their gross income their respective shares of the "undistributed taxable income" of Atlantic for the period ended May 31, 1967 pursuant to section 1373(b). Such "undistributed taxable income" reflected the reduction by Atlantic to its sales income on account of the accruals

made for the 3 percent discount and the 10 percent allowance for such period.

In his notice of deficiency to each of the individual petitioners, respondent increased the taxable
income of Atlantic by the balance in the account for
sales returns and allowances attributable to the 3 percent discount and 10 percent allowance as of May 31,
1967. This effectively increased each petitioner's
ratable share of Atlantic's undistributed taxable
income. Due to a concession by respondent, only the
propriety of the accrual by Atlantic of the 10 percent
allowance is now in issue.

The parties have agreed and stipulated that if an adjustment to Atlantic's undistributed taxable income for its fiscal year ended May 31, 1967 is mandated, a corresponding adjustment shall be made to the taxable income of Atlantic for the period ended November 30, 1967.

#### OPINION

The sole question for our determination is whether for its fiscal year ending May 31, 1967, Atlantic is entitled to accrue, either as an offset to its gross sales or as a deduction from gross income, a 10 percent record return allowance on sales of single records to its regular distributors.

Through prearrangement with its regular distributors, Atlantic uniformly granted a 10 percent record return allowance on all purchases of single records. The amount of single records each distributor was permitted to return was based upon the number of single records purchased by the distributor as of the end of a calendar quarter. An authorization for the return of records was issue to the distributor within 2 to 3 weeks after the end of the quarter. To receive credit under the authorization, however, the distributor was required to return the singles directly to Atlantic's factory. On receipt of the records at its factory, Atlantic would issue a credit memorandum to the distributor for use against future remittances.

At the end of a quarter or fiscal period, Atlantic would account for the 10 percent allowance on its books by debiting its sales returns and allowances account by the amount of the return authorization granted for that period. On the first day of the next quarter or fiscal period, it made the normal reversing entries.

When the records were delivered to its factory, a credit memorandum was issued to the distributor and the books

adjusted accordingly.6

As of its fiscal year ended May 31, 1967, Atlantic had a debit balance in its sales returns and allowances account in the amount of \$241,584. This balance related to sales made during the months of April and May of 1967. Atlantic argues that since its liability for such allowance was fixed and certain as of the end of this period, it was entitled to accrue this amount as an offset to gross sales. Respondent, on the other hand, contends such amount cannot be accrued either as an offset to gross sales or as a deduction from gross income since Atlantic's liability on account of such allowance was contingent and indeterminable as of the end of this period.

Whether we view the issue before us as one of inclusion or one of deduction, the result is the same. No accrual may be allowed on account of the 10 percent record return allowance for the period in question.

Atlantic kept its books and computed its toxable income on the accrual method of accounting for the period in question. The regulations under section 451 provide that where a taxpayer is on the accrual basis of accounting, income is includable in gross income in the taxable year

TO THE GITTE THE WAY CO. B. W. W. Words N. C. S. C. S.

The sales return and allowance account was debited and the accounts receivable credited in the amount of the credit memorandum.

- 14 -

in which "all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." See section 1.451-1(a), Income Tax Regs. See also Spring City Co. v. Commissioner, 292 U.S. 182 (1934), and Security Mills Co. v. Commissioner, 321 U.S. 281 (1944). A similar rule exists under section 461 with respect to determining the proper taxable year in which an accrual basis taxpayer may claim deductions from gross income. 7 See also United States v. Anderson, 269 U.S. 422 (1926).

Atlantic contends that pursuant to section 451,

The regulations under sec. 461 provide, in pertinent part, as follows:

<sup>\$1.461-1</sup> General rule for taxable year of deduction.

<sup>(</sup>a) General rule--\* \* \*

Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. \* \* \* While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy. \* \*

it was entitled to offset its gross sales for its fiscal year ended May 31, 1967 by the 10 percent return allowance granted its regular distributors on such sales. In support of its position, Atlantic argues that its 10 percent record return allowance merits the same treatment as the "price discounts" involved in Pittsburgh Milk Co., 26 T.C. 707 (1956). See also Atzingen-Whitehouse Dairy, Inc., 36 T.C. 173 (1961).

In that case, petitioner was in the business of selling milk and related dairy products at the whole-sale and retail levels. Petitioner sold milk at a discount below the list price fixed by the Milk Control Commission. The amount of the discount was agreed upon orally between petitioner and its customer as a result of the illegality of such arrangement. On its books, the petitioner accounted for its milk sales at the list price as fixed by law and deducted its price discounts as advertising expenses.

This Court held that petitioner had the right to receive from its customers only the list price less the discount orally agreed upon. As such, petitioner was permitted to report its sales of milk at net prices.

The issue of whether petitioner would have been able to deduct such discounts from gross income was never reached.

The facts of our case are distinguishable from those in Pittsburgh Milk Co., supra. During the period in question, Atlantic always had the right to collect the full purchase price from its regular distributors on the sales of single records. This right was in no way affected or diminished by Atlantic subsequently issuing authorizations for the return of 10 percent of the singles sold during such period. Indeed, under the payment plan in effect, the full purchase price on these singles were due and owing before any return authorization was issued with respect to such records. It so recorded each sales transaction on its books, in addition to computing its 2 percent cash discount on that basis.

Furthermore, the return authorizations issued to its distributors after the end of each quarter merely represented a right to return single records at full credit up to a specified limit. To receive credit under the authorization, the distributor was required to return the single records directly to Atlantic's factory. The price discounts in <a href="Pittsburgh Milk Co.">Pittsburgh Milk Co.</a>, <a href="Supra">Supra</a>, were not contingent upon some subsequent event. They were uniformly

Payments on the purchase of singles were due on the tenth day following the month of purchase. The return authorization was not generally issued until 2 to 3 weeks after the end of the quarter.

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granted at the time of the sale without any requirement of future performance. This Court analogized the discounts involved to "trade discounts" which we have always recognized as proper reduction against gross sales. See also American Cigar Co., 21 B.T.A. 464 (1930), affirming 66 F. 2d 425 (C.A. 2, 1933).

The 10 percent allowance involved herein can in no way be compared to the discounts in Pittsburgh Milk Co., supra, or general trade discounts. At the outset, Atlantic charged the distributors the full price (less 2 percent for prompt payment) contingent only upon the return of wholly unrelated merchandise. The 10 percent allowance in question was not a discount on current sales, but only a measure of how many obsolete records petitioner would accept for credit. Atlantic had no liability for the 10 percent return allowance until the actual return of single records to its factory. Atlantic's liability did not and could not arise until after the taxable period in question. As such, it could not, ipso facto, have any effect on the sales made during such period. This situation is to be distinguished from the 3 percent discount given by Atlantic on the sales of its albums, the accrual of which against gross sales respondent apparently now concedes.

- 18 -

For the same reason as cited above, Atlantic is also not permitted to accrue the debit balance in its sales returns and allowances account as a deduction from its gross income. Atlantic's liability on account of its 10 percent record return allowance was never irrevocably fixed or certain until the single records were actually returned to the factory. Since this event did not occur until after the period in question, no accrual on account thereof may be permitted. It is firmly established that a reserve for future or contingent liabilities cannot be deducted. Lucas v. American Code Co., 280 U.S. 445 (1930).

Atlantic contends that during the period in question, all the distributors eligible for the 10 percent allowance took maximum benefit thereof. However well this

As part of the 1954 Code, Congress enacted sec. 462 which permitted taxpayers to deduct reserves for estimated expenses. The principal requirement of the statute was that the estimated expense be attributable to the income of the taxable year and that the Treasury was satisfied that the amount of the expense could be estimated with reasonable accuracy. Upon further reflection, however, Congress realized that the Treasury would suffer substantial losses as a result of taxpayers switching to the reserve method in the transition year. Consequently, sec. 462 was repealed retroactively in 1955 by Pub. L. No. 74, 84th Cong., 1st Sess., sec. 1(b).

may be, the fact remains that Atlantic's liability with respect to such allowance was contingent upon the actual return of the singles to its factory, an event occurring subsequent to the period in question. Furthermore, its claim that the distributors always took full advantage of the allowance for each quarter is not adequately substantiated on the basis of the record before us.

The arrangement entered into between Atlantic and its regular distributors may be best described as "sale or return" contract, subject to a 10 percent limitation. This Court has consistently held that an accrual for anticipated returns in this situation is not permissible, either as an offset against gross sales or as a deduction from gross income. 10

In accordance with the above,

Decisions will be entered under Rule 155.

See J. J. Little & Ives Co., Inc., T.C. Memo. 1966-68; Scott Krauss News Agency, Inc., T.C. Memo. 1964-171.

## UNITED STATES TAX COURT

GERALD WEXLER and SHIRLEY WEXLER,

Petitioners,

v.

Docket No. 3831-71

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

# DECISION

Pursuant to the opinion of the Court filed February 13, 1975, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED and DECIDED: That there is a deficiency in income tax due from the petitioners for the taxable year 1967 in the amount of \$55,073.92.

(signed) William H. Qusaly

Judge.

Entered: MAY 23 1975

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

ALFRED D. YOUNGWOOD,
Counsel for Petitioners,
345 Park Avenue,
New York, New York 10022,
Tel. No. 212-644-8275.

MEADE WHITAKER, Chief Counsel, Internal Revenue Service.

By: (SEC) THEODORE E. DAVIS - EHH
THEODORE E. DAVIS,
Assistant Regional Counsel,
26 Federal Plaza (12th Floor),
New York, New York 10007,
Tel. No. 212-264-8134.

133a UNITED STATES TAX COURT AHMET ERTEGUN and IOANA ERTEGUN, Pecitioners, Docket No. 3830-71 v. COMMISSIONER OF INTERNAL REVENUE. Respondent. DECISION Pursuant to the opinion of the Court filed February 13, 1975, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is ORDERED and DECIDED: That there is a deficiency in income tax due from the petitioners for the taxable year 1967 in the amount of \$65,305.63. (signed) William H. Quealy Judge. · Entered: MAY 23 1975

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

# /s/ Alfred D. Youngwood

ALFRED D. YOUNGWOOD, Counsel for Petitioners, 345 Park Avenue, New York, New York 10022, Tel. No. 212-644-8275. MEADE WHITAKER, Chief Counsel, Internal Revenue Service. (Sgd) THEODORE E. DAVIS - MIR

THEODORE E. DAVIS,
Assistant Regional Counsel,
26 Federal Plaza (12th F1.),
New York, New York 10007,
Tel. No. 212-264-8134.

## UNITED STATES TAX COURT

NESUHI ERTEGUN and BELKIS ERTEGUN,

Petitioners,

V.

Docket No. 3868-71

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

## DECISION

Pursuant to the opinion of the Courc filed February 13, 1975, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED and DECIDED: That there is a deficiency in income tax due from the petitioners for the taxable year 1967 in the amount of \$36,681.14.

(signed) William H. Quealy

Judge.

Entered: MAY 23 1975

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

ALFRED D. YOUNGWOOD, Counsel for Petitioners, 345 Park Avenue,

1. ,

New York, New York 10022, Tel. No. 212-644-8275. MEADE WHITAKER, Chief Counsel, Internal Revenue Service.

By: (Sgd) THEODORE E. DAVIS - EHM

THEODORE E. DAVIS, Assistant Regional Counsel, 26 Federal Plaza (12th Floor), New York, New York 10007, Tel. No. 212-264-8134. STATE OF NEW YORK ) : ss.:
COUNTY OF NEW YORK )

Gerald Rokoff, being duly sworn, deposes and says:

I am not a party to the action, am over 18 years of age and reside at 66-25 103rd Street Forest Hills, New York 11375

On November 7, 1975 , I served the attached briefs and appendix upon the following attorney(s) at the address designated by him (them) for that purpose: Appellate Section Tax Division Department of Justice

Washington, D.C. 20530

Attention: Arthur Bailey, Esq.

Said service was made by depositing a true copy of the attached briefs and appendix enclosed in a postpaid properly addressed wrapper, in an official depository under the exclusive care and custody of the United States Post Office Department within the State of New York.

Sworn to before me this

7th /day of November

, 1975.

Gened Rola

Notary Public ...
PAUL B. GLOECKNES ...
Notary Public, State of New York.

Notary Public, State of New York,
No. 31-4517013

Qualified in New York County
Commission Expires March 30, 1978